We are pleased to provide you with the latest edition of our Financial Reporting Developments publication on accounting for transfers and servicing of financial assets. This publication has been updated for further clarification and enhancements to our interpretative guidance.

Applying ASC 860 in practice continues to be challenging. ASC 860’s scope is wide and applies to more than just securitizations. Moreover, ASC 860 relies in part on legal interpretations to determine the accounting for the transfer. Additionally, a transferor’s continuing involvement – which can vary significantly from transaction to transaction – will also affect the accounting analysis, requiring a complete understanding of both the business purpose and the form of the transaction.

The authoritative literature on accounting for transfers of financial assets continues to change. The FASB is currently considering certain amendments to the accounting and disclosure requirements for repurchase agreements and similar transactions. In addition, the AICPA is updating its guidance on the use of legal interpretations as evidential matter to support management’s assertion that a transfer of financial assets has met the isolation criterion in ASC 860.

This publication includes excerpts from and references to the FASB’s Accounting Standards Codification, interpretive guidance and examples. Practice continues to develop and additional authoritative guidance in this area could be issued subsequent to the issuance of this publication. While we will update this publication as additional authoritative guidance is issued, affected entities and interested parties should closely monitor developments in this area.

Entities that are often involved in transfers and servicing of financial assets may be familiar with many of the issues described in this publication. However, others may need the assistance of professional advisors to navigate through the accounting implications of terms and conditions associated with complex securitization and/or transfer arrangements. Ernst & Young professionals are available to answer your questions and discuss any concerns you may have.

Ernst & Young LLP

June 2013
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Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

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1 Basic principles and scope

1.1 Overview

Transfers of financial assets take many forms, including sales, assignments, factoring arrangements and securitizations. Often transfers involve the seller (transferor) having some continuing involvement either with the transferred assets or with the buyer (transferee). Some examples of continuing involvement include seller recourse provisions, servicing arrangements and call options.

Accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or with the transferee is not a controversial topic. However, transfers of financial assets with continuing involvement often raise questions about the circumstances under which the transfers should be accounted for as sales (i.e., assets are removed from the balance sheet and a resulting gain or loss is recognized) or secured borrowings (i.e., assets remain on-balance sheet with no change in measurement).

ASC 860, Transfers and Servicing, establishes principles and a control-based accounting framework for evaluating transfers of financial assets, which can be summarized as follows:

- The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions of that asset, and the entity that controls those benefits should recognize them as its asset.

- An entire financial asset cannot be divided into components prior to a transfer unless all of the components meet the definition of a participating interest.

- A transferred financial asset should be considered sold and therefore should be derecognized if “control” is surrendered.

- A transferred financial asset should be considered pledged as collateral to secure an obligation of the transferor (and therefore should not be derecognized) if the transferor has not surrendered control.

- Each liability should be recognized by the entity that is primarily liable and, accordingly, an entity that guarantees another entity’s obligation should recognize only its obligation to perform on the guarantee.

- The recognition or derecognition of financial assets and liabilities should not be affected by the sequence of transactions that led to their existence unless the effect of those transactions is to maintain effective control over a transferred financial asset.

- To the extent that a transfer of financial assets does not qualify for sale accounting, the transferor’s contractual rights or obligations related to the transferred asset are not accounted for separately if doing so would result in recognizing the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer from being accounted for as a sale. In that case, the call option is not separately recognized as a derivative asset.

- Transferors and transferees generally should account symmetrically for transfers of financial assets.

- When determining whether control has been surrendered over transferred financial assets, the transferor (and its consolidated affiliates included in the financial statements being presented) should consider its continuing involvement in the transferred financial assets and all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer.
This chapter provides an overview of the accounting model for transfers of financial assets and discusses which assets and transactions are in the scope of ASC 860. Later chapters discuss in more detail the fundamental principles of ASC 860's control-based approach, including the criteria for determining when transfers should be accounted for as sales or secured borrowings.

### 1.2 Scope and scope exceptions

While ASC 860 applies to all entities, certain transactions and activities fall outside the scope of this accounting topic.

<table>
<thead>
<tr>
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<tbody>
<tr>
<td><strong>860-10-15</strong></td>
</tr>
<tr>
<td><strong>15-4</strong> The guidance in this Topic does not apply to the following transactions and activities:</td>
</tr>
<tr>
<td>a. Except for transfers of servicing assets (see Subtopic 860-50) and for the transfers noted in the following paragraph, transfers of nonfinancial assets</td>
</tr>
<tr>
<td>b. Transfers of unrecognized financial assets, for example, minimum lease payments to be received under operating leases</td>
</tr>
<tr>
<td>c. Transfers of custody of financial assets for safekeeping</td>
</tr>
<tr>
<td>d. Contributions (for guidance on accounting for contributions, see Subtopic 958-605)</td>
</tr>
<tr>
<td>e. Transfers of ownership interests that are in substance sales of real estate (For guidance related to transfers of investments that are in substance a sale of real estate, see Topics 845 and 976. For guidance related to sale-leaseback transactions involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, and office buildings with furniture and fixtures, see Subtopic 840-40.)</td>
</tr>
<tr>
<td>f. Investments by owners or distributions to owners of a business entity</td>
</tr>
<tr>
<td>g. Employee benefits subject to the provisions of Topic 712</td>
</tr>
<tr>
<td>h. Leveraged leases subject to Topic 840</td>
</tr>
<tr>
<td>i. Money-over-money and wrap lease transactions involving nonrecourse debt subject to Topic 840.</td>
</tr>
</tbody>
</table>

Although servicing rights (e.g., mortgage servicing rights) have characteristics that are similar to financial instruments (e.g., the right to receive contractual cash flows), such rights are nonfinancial assets because they stem from executory contracts – a contract to receive future revenues for services. Transfers of servicing rights are accounted for in accordance with ASC 860-50-40. See Chapter 7, *Servicing of financial assets*, for guidance on the accounting for servicing rights, including transfers of such rights.

Transfers of assets that are derivative instruments and subject to the requirements of ASC 815, *Derivatives and Hedging*, but that are not financial assets (e.g., a forward contract to purchase a physically settled nonfinancial asset such as crude oil) are accounted for by analogy to ASC 860, pursuant to ASC 860-10-15-5.

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1.3 **Fundamentals of financial asset transfers**

To understand and appropriately apply ASC 860’s accounting framework for transfers of financial assets, certain fundamental questions must be answered, including:

- What is a financial asset?
- What is considered a transfer of financial assets and which transfers are in the scope of ASC 860?

### 1.3.1 Definition of financial asset

The definition of a financial asset must be carefully considered to determine whether a transfer is within the scope of ASC 860. All assets are not financial assets. ASC 860 applies to transfers of only recognized financial assets. A financial asset is defined in the ASC Master Glossary as follows:

**Excerpt from Accounting Standards Codification**

**Financial Asset**

Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:

- Receive cash or another financial instrument from a second entity
- Exchange other financial instruments on potentially favorable terms with the second entity.

A financial asset exists if and when two or more parties agree to payment terms and those payment terms are reduced to a contract. To be a financial asset, an asset must arise from a contractual agreement between two or more parties, not by an imposition of an obligation by one party on another.

### 1.3.2 Definition of transfer

As used in ASC 860-10, the ASC Master Glossary narrowly defines a transfer as follows:

**Excerpt from Accounting Standards Codification**

**Transfer**

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

A transfer includes the following:

- Selling a receivable
- Putting a receivable into a securitization trust
- Posting a receivable as collateral.

A transfer excludes the following:

- The origination of a receivable
- Settlement of a receivable
- The restructuring of a receivable into a security in a troubled debt restructuring.
The following are common examples of transactions that involve transfers of financial assets subject to ASC 860:

- Banker’s acceptances
- Factoring arrangements
- Loan participations
- Repurchase agreements
- Repurchase financings
- Securities lending transactions
- Securitizations
- Transfers of receivables with recourse
- Wash sales

Following is a brief discussion of each of the transfers listed above:

**Banker’s acceptances**

Banker’s acceptances provide a way for a bank to finance a customer’s purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer’s liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The principal document is a draft or bill of exchange drawn by the customer that the bank stamps to signify its acceptance of the liability to make payment on the draft on its due date.

Once the bank accepts a draft, the customer is liable to repay the bank at the time the draft matures. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The accepted draft becomes a negotiable financial instrument. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.

A risk participation is a contract between the accepting bank and a participating bank in which the participating bank agrees, in exchange for a fee, to reimburse the accepting bank in the event that the accepting bank’s customer fails to honor its liability to the accepting bank in connection with the banker’s acceptance. The participating bank becomes a guarantor of the credit of the accepting bank’s customer. See Illustration 6-4 in section 6.5.4.1 for an example of a transfer involving banker’s acceptances.

**Factoring**

Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable in their entireties are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. See Illustration 6-1 in section 6.5.4.1 for an example of a factoring arrangement accounted for as a sale.

**Loan participations**

In certain industries, a typical customer’s borrowing needs often exceed its bank’s legal lending limits. To accommodate the customer, the bank may participate the loan to other banks (that is, transfer under a participation agreement a portion of the customer’s loan to one or more participating banks).
Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending on the terms of the participation agreement.

Chapter 2, *Unit of account*, provides guidance for determining when a transfer of a portion of an entire financial asset meets the requirements for sale accounting.

**Repurchase agreements, repurchase financings and securities lending arrangements**

Repurchase agreements, commonly called repos, are securities lending transactions in which one party agrees to sell securities to another against the transfer of funds, with a simultaneous agreement to repurchase the same or equivalent securities at a specific price at a later date.

A repurchase financing involves the transfer of a previously transferred financial asset back to the initial transferor as collateral for a financing between the initial transferee and the initial transferor. A repurchase financing also typically involves the initial transferor returning the transferred financial asset, or substantially the same asset to the initial transferee when the financing is repaid on a stated date.

Securities lending involves the temporary exchange of securities, usually for other securities or cash of an equivalent value (or occasionally a mixture of cash and securities), with an obligation to redeliver a like quantity of the same securities at a future date.

Chapter 9, *Securities lending, repurchase agreements and repurchase financing arrangements*, provides an overview of common securities lending transactions and repurchase agreements, including “dollar-rolls” and repurchase financings. In addition to discussing the market participants and the typical structure of these secured borrowing arrangements, Chapter 9 also addresses the relevant accounting considerations.

**Transfers of receivables with recourse**

In a transfer of an entire receivable, a group of entire receivables, or a portion of an entire receivable with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. Sections 2.3.3, 3.4.7 and 6.5.3.5 provide additional guidance on transfers of financial assets involving transferor recourse obligations.

**Securitizations**

Securitization is a structured finance process that involves pooling and repackaging of cash-flow-producing financial assets (e.g., mortgage loans, trade receivables, credit card receivables) into securities (beneficial interests), which are then sold to investors. The FASB provides an overview of the securitization process in ASC 860-10-05-7 through 05-13. See Chapter 10, *Securitizations*, for discussion on the fundamentals of securitization transactions.

**Wash sales**

Wash sales are transactions in which an entity sells a security and then repurchases the same or substantially the same securities at some future date (within 30 days). See section 9.8 for additional guidance regarding the accounting and tax implications of wash sale transactions.
1.3.3 Examples of instruments and contractual arrangements within and outside the scope of ASC 860

Careful consideration is necessary in determining whether an asset meets the definition of a financial asset and if its transfer is within the scope of ASC 860. Instances may exist in which the item may be considered an asset, but not a financial asset as defined by US GAAP. Some instruments are more easily identified as financial assets than others. Except for transfers of servicing assets, if the transfer of an asset involves nonfinancial assets, the relevant accounting guidance is outside the scope of ASC 860. For example, guidance on the accounting for revenue related to sales of products or services includes ASC 605, Revenue Recognition, and SEC Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104).

Below is a list of some typical instruments and agreements that meet the definition of a recognized financial asset, followed by a list of certain instruments and agreements that are not considered recognized financial assets or are specifically excluded from the scope of ASC 860. These lists also include explanations of why such items are within or outside the scope of the accounting framework for transfers of financial assets.

### Illustration 1-1: Instruments and contractual arrangements within the scope of ASC 860

<table>
<thead>
<tr>
<th>Illustration 1-1: Instruments and contractual arrangements within the scope of ASC 860</th>
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</thead>
<tbody>
<tr>
<td>(a) Common stock or another form of ownership interest accounted for as a cost-method or equity-method investment</td>
</tr>
<tr>
<td>(b) Common stock of a consolidated subsidiary that holds only financial assets</td>
</tr>
<tr>
<td>(c) Derivative assets that are not financial assets such as a physically settled commodity forward contract</td>
</tr>
</tbody>
</table>

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| (d) | **Forward contract on a financial instrument that must be (or may be) physically settled** | A forward contract on a financial instrument that must be (or may be) net settled or physically settled is generally considered a financial asset because it conveys to a second entity a contractual right (a) to receive cash or another financial instrument from the first entity or (b) to exchange other financial instruments on potentially favorable terms with the first entity. ASC 405-20-40-1 applies when a forward contract is a financial liability. |
| (e) | **Investment in a controlled, but unconsolidated, investee that is measured at fair value** | An entity that carries an investment in a subsidiary at fair value will realize its investment by disposing of it rather than by realizing the values of the underlying assets through operations (e.g., a private equity fund that holds a controlling financial interest in a company). Therefore, a transfer of an investment in a subsidiary by that entity is a transfer of the investment (a financial asset), not the underlying assets and liabilities (which might include nonfinancial assets). See ASC 860-10-55-14. |
| (f) | **Investment securities and beneficial interests\(^3\) in a securitization entity (including those holding non-financial assets)** | Investment securities and beneficial interests represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |
| (g) | **Lease residual values that are guaranteed at lease inception** | ASC 840-30-40-8, which provides accounting guidance about a transfer of a lease, lease payments, or subject property, states that the residual value in a lease that is guaranteed at the inception of a lease is a financial asset. |
| (h) | **Mortgages, commercial loans, credit card receivables, installment loans and balloon notes** | Loans are typically considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from a first entity. |
| (i) | **Notes and trade receivables** | Notes and trade receivables are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from a first entity. |
| (j) | **Repurchase agreements, certain dollar rolls, securities lending transactions and repurchase financings** | Repurchase agreements, dollar rolls (involving existing securities), securities lending transactions and repurchase financings are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |
| (k) | **Sales-type and direct-financing lease receivables** | Sales-type and direct-financing lease receivables are considered financial assets because they represent a contract that conveys to a second entity a contractual right to receive cash or another financial instrument from the first entity. |

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\(^3\) Beneficial interests are further discussed in Chapter 6, *Recognition and measurement,* and Chapter 10, *Securitizations.*
### Examples of instruments and contractual arrangements that are outside the scope of ASC 860

<table>
<thead>
<tr>
<th>Illustration 1-2: Instruments and contractual arrangements that are outside the scope of ASC 860</th>
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<tbody>
<tr>
<td><strong>(a)</strong> Common stock of a consolidated subsidiary</td>
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<td><strong>(b)</strong> Contingent receivables (e.g., litigation judgment or certain insurance claims)</td>
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<td><strong>(c)</strong> Distributions of financial assets to shareholders</td>
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<td><strong>(f)</strong> Lease residual values that are guaranteed after lease inception and unguaranteed lease residuals</td>
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<td><strong>(g)</strong> Loan syndications</td>
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<td><strong>(h)</strong> Minimum lease payments to be received under an operating lease</td>
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</table>
1.4 Unit of account eligible for sale accounting

Excerpt from Accounting Standards Codification

860-10-40

40-4A To be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset (for implementation guidance, see paragraph 860-10-55-17E). An entity shall not account for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing.

40-4B If a transfer of a portion of an entire financial asset meets the definition of a participating interest, the transferor shall apply the guidance in the following paragraph [that is, ASC 860-10-40-5, the conditions for sale accounting]. If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 860-30-25-2 [that is, as a secured borrowing]. However, if the transferor transfers an entire financial asset in portions that do not individually meet the participating interest definition, the following paragraph shall be applied to the entire financial asset once all portions have been transferred.

In practice, it is difficult to determine whether a transferor has surrendered control over a component of a financial asset if the transferor continues to maintain custody of the original financial asset. Therefore, the FASB decided to limit sale accounting to transfers of entire financial assets, or a group of financial assets in its entirety, unless the transferred portion mirrors the characteristics of the original financial asset, which the FASB has defined as a participating interest. A participating interest has each of the following characteristics:

- It represents a proportionate (pro rata) ownership interest in an entire financial asset.
- It entitles each participating interest holder to all of the cash flows received from an entire financial asset in proportion to its share of ownership. However, cash flows allocated as compensation for services performed are not included in that determination provided certain conditions are met.
- It requires that each participating interest holder have the same priority and no participating interest holder is subordinated to another – that is, it involves no recourse to, or subordination by, any participating interest holder and it does not entitle any participating interest holder to receive cash before any other participating interest holder.
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

The unit of account eligible for derecognition is discussed further in Chapter 2, Unit of account.

1.5 Requirements for sale accounting

ASC 860-10-40-5 states that a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets is accounted for as a sale if and only if all of the following conditions are met:

- The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. This condition is further discussed in Chapter 3, Criteria for a sale – Legal isolation.
Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange the asset and provides more than a trivial benefit to the transferor. This condition is further discussed in Chapter 4, Criteria for a sale — Right to pledge or exchange.

The transferor, its consolidated affiliates included in the financial statements being presented or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets. This condition is further discussed in Chapter 5, Criteria for a sale — Effective control.

The objective of ASC 860-10-40-5 and related implementation guidance is to determine whether a transferor and its consolidated affiliates included in the financial statements being presented have surrendered control over transferred financial assets or third-party beneficial interests. This determination:

- Should first consider whether the transferee would be consolidated by the transferor because assets transferred to an entity that would be consolidated by the transferor would not be treated as having been sold in the financial statements being presented (see also section 1.5.1 for guidance related to the consolidated transferee’s accounting)
- Should consider the transferor’s continuing involvement in the transferred financial assets, including the continuing involvement of the transferor’s consolidated affiliates included in the financial statements being presented, and its agents
- Requires the use of judgment that should consider all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer, even if they were not entered into at the time of the transfer

### 1.5.1 Transactions between entities under common control

ASC 860-10-55-78 clarifies that a transfer from one subsidiary (the transferor) to another subsidiary (the transferee) of a common parent would be accounted for as a sale in each subsidiary’s separate-entity financial statements if both of the following requirements are met:

- All of the conditions in ASC 860-10-40-5 (including the condition on isolation of the transferred financial assets) are met.
- The transferee’s assets and liabilities are not consolidated into the separate-entity financial statements of the transferor.

In a transfer between two subsidiaries of a common parent, the transferor-subsidiary should not consider parent involvements with the transferred financial assets in applying ASC 860-10-40-5.\(^4\)

### Transfer of financial assets to a consolidated transferee

ASC 860-10-55-17D clarifies that if the transferee is a consolidated subsidiary of the transferor (its parent), the transferee should recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral (e.g., a repurchase agreement that does not meet the conditions for sale accounting).

\(^4\) See ASC 860-10-40-4.
1.6 Recognition and measurement

Upon completion of a transfer of a financial asset (or participating interest) to be accounted for as a sale, an entity should recognize in earnings any resulting gain or loss as determined under ASC 860-20-40-1A and 40-1B. The proceeds consist of the cash and any other assets obtained in the transfer, including beneficial interests and separately recognized servicing assets, less any liabilities incurred, including separately recognized servicing liabilities. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received. ASC 860 requires that all proceeds and reductions of proceeds from a sale be initially measured at fair value.

For transfers involving participating interests, the participating interests in financial assets that continue to be held by the transferor are not part of the proceeds of the transfer. Rather, the transferor has surrendered control over only those transferred participating interests transferred to third parties. Consequently, the carrying amount of the participating interests that the transferor continues to hold should be measured at the date of the transfer by allocating the previous carrying amount between the portions of the asset transferred and the portion that continues to be held by the transferor based on their relative fair values.

Assets and liabilities recognized as a result of applying ASC 860 subsequently will be accounted for as if they had been acquired or incurred in an independent transaction, in accordance with other US GAAP.

See Chapter 6, Recognition and measurement, for guidance on the recognition and measurement requirements related to the transfer of financial assets or participating interests that satisfy the conditions for sale accounting.

1.7 Interests held after a transfer of financial assets accounted for as sold

1.7.1 Servicing assets and liabilities

An entity that transfers financial assets in a transfer that qualifies for sale accounting and retains servicing rights will recognize a servicing asset or liability, depending on whether the servicing fee is above or below “adequate compensation.” The ASC Master Glossary defines adequate compensation as the “amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing.” The key point of this definition is that adequate compensation is the amount demanded by the marketplace to perform the specific type of servicing; it does not vary according to the specific servicing costs of the servicer.

The recognition and measurement of a servicing asset or servicing liability should occur each time an entity undertakes an obligation to service financial assets in either of the following situations:

- A servicer’s transfer of an entire financial asset, a group of entire financial assets or a participating interest that meets the requirements for sale accounting
- An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented

The resulting servicing asset or servicing liability should be recognized and initially measured at fair value. However, an entity is permitted to choose either the amortization method or the fair-value-measurement method to subsequently measure each class of separately recognized servicing assets or servicing liabilities.

The accounting for servicing assets and servicing liabilities is further discussed in Chapter 7, Servicing of financial assets.
1.7.2 Financial assets subject to prepayment

Financial assets, except for instruments that are within the scope of ASC 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment should be subsequently measured like investments in debt securities classified as available for sale or trading under ASC 320, Investments – Debt and Equity Securities.

Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of securities are included in the scope of ASC 320 and all relevant provisions of that accounting topic (including the disclosure requirements) should be applied.

See section 6.5 for a further discussion of the accounting for typical assets obtained and liabilities incurred as proceeds from transfers of financial assets that meet the requirements for sale accounting.

1.8 Changes that result in a transferor regaining effective control of previously transferred financial assets

A change in law or other circumstance (e.g., resolution of a contingency) may result in (1) a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (as defined in ASC 860-10-40-6A) or (2) the transferor’s regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions for sale treatment in ASC 860-10-40-5 are no longer met. Such changes, unless they arise from circumstances specifically exempted by ASC 860-20-25-9 (e.g., a change in market price that causes an option to become in the money), should be accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed (ASC 860-20-25-1).

The accounting for changes that result in the transferor regaining control of previously sold assets is complex and is further discussed in section 6.6.

1.9 Secured borrowings and collateral

If a transfer of financial assets fails to meet ASC 860-10-40-5’s criteria for sale accounting, the transferor and transferee should account for the transaction as a secured borrowing (financing) with a pledge of collateral. In a secured borrowing the transferor (debtor) recognizes any proceeds (e.g., cash) received as a liability while continuing to report the transferred assets on its balance sheet with no change in the basis of accounting. In most cases, the transferee (lender) records a receivable (loan) for the amount of the funds advanced. In subsequent periods, the transferor recognizes any income on the transferred assets and any expense incurred on the liability based on the requirements of other ASC topics.

In many financing transactions, a debtor may grant a security interest in certain assets to a lender (secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or re-pledge collateral held under a pledge. In a transfer of collateral that is accounted for as a secured borrowing, the recognition of the collateral by the secured party and the reclassification of the collateral by the debtor depend on whether the secured party has the right to sell or re-pledge the collateral and whether the debtor has defaulted under the terms of the borrowing.

See Chapter 8, Secured borrowings and collateral, for additional guidance.
1.10 Disclosures

The disclosure requirements of ASC 860, which apply to both public and nonpublic entities, are designed to provide users of the financial statements with an understanding of all of the following:

- A transferor’s continuing involvement in transferred financial assets
- The nature of any restriction on assets reported by a transferor in its statement of financial position, including the carrying amounts of such assets
- How servicing assets and servicing liabilities are reported by a transferor under ASC 860
- How a transfer of financial assets affects an entity’s financial position, financial performance and cash flows

To that end, ASC 860 requires specific disclosures about each of the following:

- Securitizations or asset-backed financing arrangements accounted for as sales when the transferor has continuing involvement
- Transfers of financial assets accounted for as secured borrowings
- Collateral
- All servicing assets and servicing liabilities
- Servicing assets and servicing liabilities subsequently measured at fair value
- Servicing assets and servicing liabilities subsequently amortized

Refer to Chapter 11, Disclosures, for a complete listing of ASC 860’s disclosure requirements.
1.11 Transfer decision tree

Does the transaction represent a transfer of financial assets? [See Chapter 1]

Yes

No

Does the transaction represent a transfer of an entire financial asset (or group of entire financial assets)? [See Chapter 2 and ASC 860-10-40-4A]

Yes

No

Does the transferred portion of the financial asset meet the definition of a participating interest? [See Chapter 2 and ASC 860-10-40-6A]

Yes

No

Have the transferred financial assets been legally isolated from the transferor and its consolidated affiliates (even in the event of bankruptcy or other receivership)? [See Chapter 3 and ASC 860-10-40-5(a)]

Yes

No

Does each transferee have the right to pledge or exchange the assets it received, and no constraint on the transferee provides more than a trivial benefit to the transferor? [See Chapter 4 and ASC 860-10-40-5(b)]

Yes

No

Has the transferor, its consolidated affiliates included in the financial statements being presented, or its agents maintained effective control over the transferred financial assets or third-party beneficial interests related to those financial assets? [See Chapter 5 and ASC 860-10-40-5(c)]

Yes

No

Record the transfer of financial assets as a sale and recognize any gain or loss [See Chapter 6 and ASC 860-20-25-1]²

Record the transfer of financial assets as a secured borrowing [See Chapter 8 and ASC 860-30-25-2]³

Consolidate the transferee in accordance with ASC 810; sale accounting not permitted for transferred financial asset in consolidated financial statements¹

Transaction is not subject to ASC 860, Transfers and Servicing; apply other US GAAP

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¹ If the transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor, typically a legal opinion is not required and the other sales criteria of ASC 860-10-40-5 are satisfied.

² Special “look-through” provisions apply when the transferee is an entity whose sole purpose is to facilitate a securitization or asset-backed financing.

³ Pursuant to ASC 860-20-25-8 through 25-9, transfers accounted for as sales must be continuously evaluated for changes that may result in the transferor regaining effective control of the previously transferred financial assets.

⁴ The consolidated transferee should recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral (see ASC 860-10-15-17D).
Questions and interpretive responses

Question 1-1  Transfers of an interest in a consolidated special-purpose entity

Assume an entity transfers loans to a consolidated special-purpose entity (SPE) in exchange for cash and subordinate beneficial interests. Concurrently, the SPE issues senior beneficial interests, which pay a prescribed rate of return each period, to third-party investors. Would the transfer of senior beneficial interests be within the scope of ASC 810, Consolidations, which may result in the proceeds received being accounted for as noncontrolling equity interests? Or, would this transaction be within the scope of ASC 860, which would require the entity to determine whether the transfer should be accounted for as a sale of financial assets or as a secured borrowing (i.e., collateralized debt)?

It depends on whether the subsidiary meets the definition of a “business.” ASC 860-10-15-4 notes that the guidance in ASC 860 does not apply to “investments by owners or distributions to owners of a business entity.” Additionally, the SEC staff has indicated that “when a subsidiary is created simply to issue beneficial interests backed by financial assets rather than to engage in substantive business activities, [the SEC staff has] concluded that sales of interests in the subsidiary should be viewed as transfers of interests in the financial assets themselves.”

Accordingly, if the subsidiary in the example described above is a “business,” the guidance in ASC 810-10 should be applied to determine whether the proceeds received should be accounted for as noncontrolling equity interests (assuming the beneficial interests are classified as equity instruments). Alternatively, if a subsidiary does not meet the definition of business (which is likely the case in the above example), the beneficial interests in such entities are effectively transfers of interests in the financial assets of the subsidiary and are within the scope of ASC 860. In that case, sale accounting would be appropriate only if both the initial transfer of loans to the SPE and the subsequent transfer of beneficial interests to third party investors meets the derecognition requirements of ASC 860 and the transferor is not the primary beneficiary of the SPE under ASC 810.

Question 1-2  Transfers of unearned receivables

A consumer electronics retailer (Company A) offers a private label credit card for its customers to finance their purchases. Customers often purchase extended warranty contracts in addition to their electronics purchases. The service related to the warranty is provided by Company A. Company A has entered into a consumer finance receivable securitization program in which it regularly transfers the receivables from its private label credit card. Is Company A allowed to obtain sale treatment under ASC 860 for the portion of the receivables related to the extended warranty?

No. The finance receivables related to the sale of the extended warranty product are not considered a financial asset subject to ASC 860 until the service has been provided and revenue has been appropriately recognized. The proceeds received for the sale of future revenue should be accounted for as either debt or deferred income pursuant to ASC 470-10-25-2.

Application of the sale criteria for financial instruments that have the potential to be assets or liabilities

What derecognition criteria should be applied to transfers of financial instruments that have the potential to be financial assets or financial liabilities (e.g., forward contracts and swaps)? Additionally, does different guidance apply to a transfer of a recognized derivative instrument that is not a financial instrument?

ASC 860-10-40-40 states that transfers of financial instruments that have the potential to be financial assets or financial liabilities must meet the conditions of both ASC 860-10-40-5 and ASC 405-20-40-1 to be derecognized. ASC 815-10-40-2 states that the same criteria apply to transfers of nonfinancial derivative instruments.
2

Unit of account

2.1 Introduction

The derecognition criteria of ASC 860-10-40-5 is applied only to the transfer of (1) an entire financial asset, (2) a group of entire financial assets or (3) a participating interest, as defined, in an entire financial asset. This chapter discusses considerations in determining what constitutes an entire financial asset and whether a portion of a transferred financial asset meets the definition of a participating interest.

2.2 Entire financial asset

As explained in ASC 860-10-40-4A, determining what constitutes an entire financial asset requires a reporting entity to consider both (a) the financial asset's legal form and (b) what rights and characteristics it conveys to the transferee(s). ASC 860-10-55-17F through 860-10-55-17H provides examples that illustrate these concepts:

Excerpt from Accounting Standards Codification

Meaning of the Term Entire Financial Asset

860-10-55

55-17F A loan to one borrower in accordance with a single contract that is transferred to a securitization entity before securitization shall be considered an entire financial asset. Similarly, a beneficial interest in securitized financial assets after the securitization process has been completed shall be considered an entire financial asset. In contrast, a transferred interest in an individual loan shall not be considered an entire financial asset; however, if the transferred interest meets the definition of a participating interest, the participating interest would be eligible for sale accounting.

55-17G In a transaction in which the transferor creates an interest-only strip from a loan and transfers the interest-only strip, the interest-only strip does not meet the definition of an entire financial asset (and an interest-only strip does not meet the definition of a participating interest; therefore, sale accounting would be precluded). In contrast, if an entire financial asset is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only strip as proceeds from the sale. An interest-only strip received as proceeds of a sale is an entire financial asset for purposes of evaluating any future transfers that could then be eligible for sale accounting.

55-17H If multiple advances are made to one borrower in accordance with a single contract (such as a line of credit, credit card loan, or a construction loan), an advance on that contract would be a separate unit of account if the advance retains its identity, does not become part of a larger loan balance, and is transferred in its entirety. However, if the transferor transfers an advance in its entirety and the advance loses its identity and becomes part of a larger loan balance, the transfer would be eligible for sale accounting only if the transfer of the advance does not result in the transferor retaining any interest in the larger balance or if the transfer results in the transferor's interest in the larger balance meeting the definition of a participating interest. Similarly, if the transferor transfers an interest in an advance that has lost its identity, the interest must be a participating interest in the larger balance to be eligible for sale accounting.
Refer to Chapter 1, *Basic principles and scope*, for examples of common transfers of financial assets that may involve transfers of entire financial assets or groups of entire financial assets.

### 2.3 Participating interest

If the financial asset being evaluated represents an ownership interest in a portion of an entire financial asset, that ownership interest will need to meet the definition of a participating interest to be eligible for sale accounting. Inherent in this concept is that an entire financial asset cannot be divided into components unless all of the resulting portions mirror the entire financial asset in a way that the transferor and all transferees proportionately share all of the rights, risks and benefits of the entire financial asset.

**Excerpt from Accounting Standards Codification**

**Meaning of the Term Participating Interest**

*860-10-40-6A*

A participating interest has all of the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor’s interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders (including any interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) in an amount equal to their share of ownership. An allocation of specified cash flows is not an allowed characteristic of a participating interest unless each cash flow is proportionately allocated to the participating interest holders. In determining proportionate cash flows:

1. Cash flows allocated as compensation for services performed, if any, shall not be included provided those cash flows meet both of the following conditions:
   
   i. They are not subordinate to the proportionate cash flows of the participating interest.
   
   ii. They are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace.

2. Any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The priority of cash flows has all of the following characteristics:

1. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority.
2. No participating interest holder’s interest is subordinated to the interest of another participating interest holder.

3. The priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder.

4. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than any of the following:
   
i. Standard representations and warranties
   
ii. Ongoing contractual obligations to service the entire financial asset and administer the transfer contract
   
iii. Contractual obligations to share in any set-off benefits received by any participating interest holder.

That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

A set-off right is not an impediment to meeting the participating interest definition. For implementation guidance on the application of the term participating interest, see paragraph 860-10-55-17D.

As noted in the definition above, the requirements for a participating interest do not allow for the allocation of specified cash flows unless each cash flow is proportionately allocated to the participating interest holders. ASC 860-10-55-17I provides the following examples illustrating the requirements of a participating interest:

<table>
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<tr>
<td><strong>860-10-55-17I</strong></td>
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<tr>
<td>a. In the circumstance of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan.</td>
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<tr>
<td>b. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payments on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan.</td>
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<tr>
<td>c. In other circumstances, a transferor may transfer a portion of an individual loan that represents either a senior interest or a junior interest in an individual loan. In both of those circumstances, the transferor would account for the transfer as a secured borrowing because the senior interest or junior interest in the loan do not meet the requirements to be participating interests (see paragraph 860-10-40-6A(c)).</td>
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</tbody>
</table>
ASC 860-10-40-6A and 860-10-55-17M state that certain cash flows should be excluded when evaluating whether all cash flows received from the entire financial asset are divided proportionately among the participating interest holders. Such exclusions include compensation for services performed, proceeds from sales of participating interests and recourse in the form of an independent third-party guarantee, which are discussed further below.

### 2.3.1 Compensation for services performed

As noted in ASC 860-10-55-17J, compensation for services performed includes all of the following:

- Loan origination fees paid by the borrower to the transferor
- Fees necessary to arrange and complete the transfer paid by the transferee to the transferor
- Fees for servicing the financial asset (i.e., compensation to process the collection and remittance of contractual cash flows of a financial asset)

Pursuant to ASC 860-10-40-6A, cash flows allocated as compensation for services performed, if any, are excluded from the cash flows required to be allocated proportionately to participating interest holders provided payment for such services are both:

- Not subordinate to the proportionate cash flows allocated to the participating interest holders
- Not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace (“adequate compensation,” as defined in the ASC Master Glossary)

The FASB included the second criterion to prevent an excess interest spread retained in the entire financial asset being classified as a servicing fee. Servicing fee payments that are significantly above “adequate compensation” essentially entitle the recipient to a disproportionate interest in the contractual cash flows of the underlying financial asset, thus preventing the transferred portion from meeting the definition of a participating interest.

The FASB does not define “not significantly above” adequate compensation. Determining whether amounts are not significantly above adequate compensation is a matter of facts and circumstances requiring use of professional judgment. Refer to section 7.3.2 for further information about the meaning of adequate compensation. We believe this determination requires consideration of various quantitative and qualitative factors, including:

- The type of financial asset being serviced – for example, compared to a fixed-rate corporate loan with a quarterly payment schedule, a variable-rate loan backed by commercial real estate with scheduled monthly interest payments may require greater servicing effort, and demand a higher servicing fee, because of the interest rate resets and higher frequency of payments that require processing
- The inherent risks associated with the financial asset being serviced – for example, the credit worthiness of the underlying debtor (i.e., the likelihood of default) and market conditions may require varying degrees of servicing efforts and commensurate compensation
- The availability and reliability of observable market inputs to estimate adequate compensation and the degree to which the valuation inputs (i.e., market-based cost and profit elements) typically vary (e.g., based on asset class and size) – for example, the absence of observable market inputs may result in a wider reasonably estimated range of values that may constitute adequate compensation
The rights and obligations conveyed by the servicing agreement relative to what is customary in the market for similar arrangements to service similar participating interests – for example, whether the arrangement entitles the servicer to other sources of income, including interest “float” and ancillary fees (e.g., late fees) and the interaction of these rights compared to customary arrangements and related fees.

Entities should evaluate any cash flows allocated as compensation for services performed in connection with the transfer of a portion of an entire financial asset and document the basis for its participating interest conclusions.

### 2.3.2 Proceeds from sales of participating interests

Because a participating interest in an entire financial asset may be sold after the purchase or origination of the financial asset itself (or after the purchaser or lender has committed to purchase or originate the financial asset), the contractual interest rate passed through for the portion of the financial asset sold may differ from market interest rates at the time of sale of the participating interest. Differences between the asset’s contractual and market interest rates at the time of sale (which may result from changes in the risk-free rate, changes in credit spreads or other factors) will likely result in portions of financial assets being sold at either discounts or premiums to the face amount of the participating interest. If the participating interest entitles the transferee to a current market interest rate that differs from the financial asset’s contractual interest rate, the portion transferred would not be considered a participating interest (see ASC 860-10-40-6A(b)(2)).

**Illustration 2-1: Considering changes in market interest rates when evaluating whether transferred portions of an entire financial asset meet the participating interest requirements**

An entity originates a loan of $100,000 with a contractual coupon of 5% and subsequently sells a 50% interest in that loan in a declining interest rate environment where market rates for the loan are 4%.

If the transferor retains an interest only-strip to compensate for the difference, the transaction would fail to meet the participating interest requirement under ASC 860-10-40-6A(b). Similarly, in a rising interest rate environment, if the transferor agrees to pay an interest rate higher than the loan’s stated coupon, the transaction would not meet the definition of a participating interest.

However, if the transferor and transferee agree to make up the difference in interest rates through higher or lower proceeds up-front, rather than by retaining a future right and/or obligation, the transfer could satisfy the requirements of a participating interest, and therefore, would be eligible for derecognition.

### 2.3.3 Guarantees and recourse provisions

ASC 860-10-40-6A(c)(4)(i) explains that recourse in the form of standard representation and warranties would not preclude a portion of an entire financial asset from being considered a participating interest. Additionally, the implementation guidance in ASC 860-10-55-17M indicates that an independent third-party guarantee, including any cash flows allocated to a third-party guarantor for the guarantee fee is excluded from the participating interest evaluation.

As noted in the Statement 166’s Basis for Conclusions, the FASB reasoned an independent third-party guarantee should be excluded because it is an arrangement in which a third-party guarantor would assume a participating interest in the event of default and, accordingly, does not result in recourse to the transferor or other participating interest holders. See Illustration 2-3 in section 2.3.6 for an example of how a third-party guarantee should be considered in the participating interest determination.
Conversely, recourse provided by the transferor (other than in the form of standard representations and warranties) would preclude the transferred portion of an entire financial asset from meeting the definition of a participating interest. As explained in ASC 860-10-55-46(b), a transfer of a portion of a receivable with recourse, other than that permitted in ASC 860-10-40-6A(c)(4), does not meet the requirements of a participating interest and should be accounted for as a secured borrowing. For example, in certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined time frame of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest (see ASC 860-10-55-17L). However, once the recourse provision expires, the transferred portion should be reevaluated to determine if it meets the participating interest definition.

2.3.4 Other exceptions – Rights of set-off

As further discussed in Chapter 3, Criteria for a sale – Legal isolation, in the event of bankruptcy or receivership of the transferor, set-off rights of the borrower do not prevent a transfer of a portion of a financial asset from meeting the legal isolation requirements as long as each participating interest holder is contractually entitled to proportionately share in any set-off benefits received.

2.3.5 Accounting for transfers that fail the participating interest requirements

A transfer of a portion of an entire financial asset that fails to meet the requirements of a participating interest is accounted for as a secured borrowing because the participating interest criteria are a prerequisite for being able to apply the derecognition requirements of ASC 860-10-40-5 to transfers of portions of an entire financial asset.

Additionally, such a transfer causes all other transfers associated with the same entire financial asset to fail the requirements of a participating interest, thus precluding sale accounting for those transfers and requiring the transferor to re-recognize the transferred asset(s). The transferor initially measures the financial assets “reacquired” from the transferees and related liabilities at fair value on the date of the subsequent transfer of a portion of a financial asset that did not meet the participating interest criteria. The fair value of the reacquired financial assets would typically approximate the fair value of the related liabilities assumed by the original transferor when such liabilities are non-recourse.

See Illustration 2-2(a) in section 2.3.6 and questions 2-1 to 2-4 for additional interpretive guidance.

2.3.6 Illustrative examples

The following examples illustrate the participating interest requirements:

<table>
<thead>
<tr>
<th>Illustration 2-2: Transfers of portions of an entire financial asset that meet the participation interest requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A originates a loan to Company B (the Borrower) with a principal amount of $100,000 and an interest rate of 8%. One month later, Bank A transfers a 30% participating interest to Investor C for $30,000 and retains servicing rights. Bank A is obligated to pass through 30% of both the remaining contractual principal and interest cash flows received from the borrower (after deducting servicing fees) to Investor C. The compensation received by Bank A to service the loan is neither significantly in excess nor below &quot;adequate compensation.&quot; In addition, any servicing payments are deducted from the cash flows, if any, received from the underlying borrower (Company B) and are senior in priority to the proportionate cash flows allocated to the participating interest holder(s).</td>
</tr>
</tbody>
</table>
Months later, Bank A transfers an additional 20% participating interest in the remaining original loan to Trust D. Bank A is obligated to pass-through 20% of both the remaining contractual principal and interest cash flows received from the borrower (after deducting servicing fees) to Investor C. Because of the second transfer, Bank A, Investor C and Trust D are legally entitled to 50%, 30% and 20%, respectively, of the original loan’s remaining contractual principal and interest cash flows (after deducting Bank A’s servicing fee). In this example, both the initial and subsequent transfers meet the requirements of a participating interest and are accounted for as sales assuming the derecognition requirements of ASC 860-10-40-5 have been met.

Illustration 2-2(a): Transfers of portions of an entire financial asset that do not meet the participation interest requirements

Assume the same facts as in Illustration 2-2, except that the second transfer conveys 20% of the original loan’s remaining principal balance, but only 19% of the remaining interest cash flows.

In this instance, the transfer would not meet the definition of a participating interest because the transfer would not convey to Trust D a proportionate ownership interest in an entire financial asset. Additionally, the transfer to Trust D causes the previous transfer to Investor C to also fail the requirements of a participating interest, thus precluding sale accounting for all transfers associated with the loan to Company B.

After that change, Bank A (the transferor) recognizes in its financial statements the previously transferred financial assets (i.e., the portions of the loan to Company B that previously qualified as a participating interest) with corresponding liabilities to the former transferee(s). Bank A initially measures the financial asset “reacquired” from Investor C and the related liability at fair value on the date of the transaction with Trust D, as if Bank A purchased the transferred financial asset and assumed the liability on that date. Bank A would report on its balance sheet the entire Company B loan (70% of which would be measured at historical carrying value and 30% of which would be measured based on its fair value at the date of the transaction with Trust D) as an asset, with corresponding non-recourse liabilities for its contractual obligation to pass-through portions of the loan’s cash flows to both Investor C (measured at fair value on the date of the transaction with Trust D) and Trust D (measured at the consideration received from Trust D). The fair value of the loan “reacquired” from Investor C approximates the fair value of the related non-recourse liability assumed by Bank A.

Illustration 2-2(b): Eligibility for sale accounting when an entire financial asset is transferred in portions that individually do not meet the participating interest requirements

Assume the same facts as in Illustration 2-2(a), except that Bank A transfers its remaining 50% and 51% ownership interest in the contractual principal and interest cash flows of the Company B loan to Hedge Fund E. At this point, because Bank A has transferred all of its ownership interest in the entire loan (assuming it has met all of the derecognition requirements of ASC 860-10-40-5) it would derecognize the loan receivable, the liabilities to Investor C and Trust D and recognize any resulting gain or loss on sale.
The following example illustrates cash flows that may be excluded from a participating interest determination. It assumes that all other participating interest requirements are met.

Bank A originates a ten-year loan to Company B (the Borrower) with a contractual principal amount and interest rate of $200,000 and 7%, respectively. The loan meets the qualifications of the Small Business Administration (SBA) and the lender and has received, in exchange for a fee, an SBA guarantee for 75% of the loan’s contractual payments in the event the borrower defaults. Shortly after its origination, Bank A transfers the guaranteed portion (i.e., 75%) of the qualifying SBA loan to Bank C for $157,500 (a 5% premium) and retains servicing rights. Assume the following:

- Bank A and Bank C have the same priority and neither one is subordinated to the other – that is, neither Bank A nor Bank C are entitled to receive cash from the borrower before the other.
- The servicing fee is 100 basis points (1%) per annum of the outstanding balance of the SBA guaranteed portion and is not subordinate to the proportionate cash flows of the participating interests.
- The servicing fee is not considered significantly above an amount that would fairly compensate a substitute service provider.\(^6\)
- In the event of default by the borrower, Bank A has no recourse to Bank C; however, Bank C is entitled to recourse from the SBA through the guarantee.
- A one-time guarantee fee equal to 3% of the total amount guaranteed (i.e., 3% of $150,000, or $4,500) is assessed by and remitted to the SBA at the loan’s origination.
- Neither Bank A nor Bank C has the right to pledge or exchange the entire loan unless both entities agree to pledge or exchange the entire loan.

Accordingly, the total cash flows received from the borrower of the loan will be allocated among Bank A and Bank C as follows:

<table>
<thead>
<tr>
<th>Cash flows(^7)</th>
<th>Bank A</th>
<th>Bank C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>$ 50,000</td>
<td>$ 150,000</td>
</tr>
<tr>
<td>Interest</td>
<td>19,665</td>
<td>58,995</td>
</tr>
<tr>
<td><strong>Total principal and interest cash flows</strong></td>
<td><strong>69,665</strong></td>
<td><strong>208,995</strong></td>
</tr>
<tr>
<td><em>Proportionate interest of principal and interest</em></td>
<td>25%</td>
<td>75%</td>
</tr>
<tr>
<td>Servicing fee (total amount over the life of the loan)</td>
<td>8,300</td>
<td>(8,300)</td>
</tr>
<tr>
<td>Guarantee premium</td>
<td>(4,500)</td>
<td>n/a</td>
</tr>
<tr>
<td>Premium on transfer (i.e., price in excess of par value)</td>
<td>7,500</td>
<td>(7,500)</td>
</tr>
<tr>
<td><strong>Total cash flows</strong></td>
<td><strong>$ 80,965</strong></td>
<td><strong>$ 193,195</strong></td>
</tr>
</tbody>
</table>

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\(^6\) This example assumes that the 100 basis point servicing fee does not entitle a servicer to an amount that would be significantly above adequate compensation. It is meant only for illustrative purposes. Any evaluation of the adequacy of servicing fees should be based on the specific facts and circumstances.

\(^7\) The cash flows in the table represent those of an amortizing loan and assume no prepayments.
The following cash flows are appropriately excluded from the determination of whether the cash flows are divided proportionately among participating interest holders:

- The cash flows allocated to Bank A as compensation for servicing
- The guarantee premium paid by Bank A (transferor) to the SBA (i.e., a third-party guarantor)
- The premium paid by Bank C (transferee) to Bank A to acquire the participating interest

Because the contractual cash flows from the transferred loan (i.e., principal and interest amounts) are proportionately allocated to the participating interest holders, the portion of the loan transferred to Bank C meets the definition of a participating interest.  

Questions and interpretive responses

**Question 2-1**  
**Investments in sales-type or direct-financing lease receivables**

May a portion of an interest in the minimum lease payments (but not the unguaranteed residual value) qualify as a participating interest?

Minimum lease payments are financial assets in the scope of ASC 860. Moreover, in this question, they represent the entire financial asset eligible for derecognition. As such, if the transferred interest in the minimum lease payments represents a participating interest, that interest is eligible for sale accounting. The unguaranteed residual value is not a financial asset and therefore is not subject to the requirements of ASC 860.

**Question 2-2**  
**Interests in lease residual value guaranteed at inception**

May a pro-rata portion of the minimum lease payments from a sales-type or direct-financing lease receivable secured by leased assets be considered a participating interest without also selling a pro-rata portion of the residual value guaranteed at inception?

We believe the answer to this question depends on whether the residual value is a separate unit of account, and that determination is based on whether the residual value is guaranteed by the lessee or by a third-party guarantor (i.e., unrelated to the lessee and lessor).

If the lessee guarantees the residual value, the minimum lease payments and residual value should be viewed as a single unit of account. This is consistent with the guidance about the unit of account eligible for sales accounting in ASC 860-10-40-4A, which states, “[t]he legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset.”

If the residual value is guaranteed by a third party, we believe that the residual value may be excluded from the determination of whether a portion of the gross investment in lease receivables meets the definition of a participating interest because that residual value portion is an obligation of a party different than the obligor under the lease contract. This conclusion is consistent with the implementation

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8 Any guarantee payments made by the SBA to Bank C in the event of the borrower’s default are also excluded from the participating interest determination because (1) the guarantee is provided by an entity (SBA) unrelated to the transferor (Bank A) and (2) does not provide the transferee (Bank C) any recourse against the transferor. See section 2.3.3 and ASC 860-10-55-17M for further discussion about whether a guarantee precludes a portion of a financial asset from meeting the definition of a participating interest.
guidance in ASC 860-10-55-17M, which states “[r]ecourse in the form of an independent third-party guarantee shall be excluded from the evaluation of whether the participating interest definition is met.”

However, the guidance about the minimum-lease-payments criterion in ASC 840-10-25-7 explains that from the lessor’s perspective, minimum lease payments include, among other things, any guarantee of the residual value or of rental payments beyond the lease term by a third-party unrelated to either the lessee or the lessor. Based in part on this guidance, we understand that the FASB staff believes that an entity may include (or exclude) a third-party guarantee of the residual value as an accounting policy election that should be consistently applied when evaluating whether a portion of a sales-type or direct-financing receivable meets the definition of a participating interest in an entire financial asset. However, we understand the FASB staff believes it would not be appropriate for an entity to analogize to these views when evaluating other transactions with similar characteristics. Additionally, this policy should be consistently applied and disclosed as an accounting policy election.

**Question 2-3**

**Determining the affect of guarantees or recourse provisions**

How does a guarantee or recourse arrangement affect the determination of whether a transfer of a portion of an entire financial asset meets the requirements of a participating interest?

A third-party guarantee or recourse arrangement is considered a separate unit of account that is specifically excluded from the evaluation of whether the participating interest definition is met. Similarly, cash flows allocated to a third-party guarantor (e.g., premiums or fees) are excluded from the determination of whether the cash flows are divided proportionately among the participating interest holders. Refer to section 2.3.3 for implementation guidance about addressing recourse in a participating interest.

Conversely, credit guarantees or recourse arrangements provided by the transferor in conjunction with the sale of a portion of an entire financial asset are forms of continuing involvement that would cause the transfer to fail the participating interest requirements. For example, in certain loan participations, the transferee may retain recourse requiring the transferor to reimburse it for any premiums paid if the entire underlying loan is prepaid within 90 days of the transfer date. This type of recourse substantively differs from standard representations and warranties and, therefore, would preclude the transferred portion from meeting the participating interest definition. However, once this type of 90-day recourse provision expires, the transfer should be reevaluated to determine if it meets the participating interest criteria.

**Question 2-4**

**Traditional commercial paper programs**

May an entity transfer an entire financial asset to a securitization entity (e.g., a commercial paper conduit) in exchange for cash and a subordinated interest in the transferred asset (e.g., a deferred purchase price contingent on the performance of the transferred assets) and achieve sale accounting? Would the entity reach the same accounting conclusion if it transferred only a portion of a financial asset?

If the transfer involves an entire financial asset (or a group of financial assets in its entirety), sale accounting is permissible if each of the derecognition conditions in ASC 860-10-40-5 have been met. The subordinated interest would be evaluated as part of the proceeds received similar to the interest-only strip referred to in ASC 860-10-55-17G.

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9 See ASC 860-10-40-6A(cX4) for the requirement related to recourse when evaluating whether a portion of a financial asset is a participating interest.
A transfer of only a portion of a financial asset would not qualify for sale accounting. Prior to ASU 2009-16, transfers to commercial paper conduits often involved an entity transferring a senior interest in a pool of trade receivables (typically through a “two-step securitization”) while retaining a junior or subordinated interest in the transferred assets. After the adoption of ASU 2009-16, such transfers would not be eligible for sale accounting because the portion of the financial assets transferred to the commercial paper conduit (i.e., the senior interest) would not meet the requirements of a participating interest because each of the participating interest holders would not have the same priority to the cash flows from the underlying asset (see ASC 860-10-40-4A).

While the economic substance (risks and rewards) of the transfer of a (1) senior interest in an individual financial asset and (2) an entire financial asset in exchange for cash and a subordinated non-recourse interest in the transferred asset is similar, the legal form of the transfer is different. ASU 2009-16 amends and limits the unit of account eligible for derecognition. An entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest (see ASC 860-10-40-6A).
3 Criteria for a sale – Legal isolation

3.1 Overview

This chapter focuses on the first criterion for sale accounting outlined in ASC 860-10-40-5, commonly referred to as the “legal isolation criterion.”

Excerpt from Accounting Standards Codification

Conditions for a Sale of Financial Assets

860-10-40-5

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

a. Isolation of transferred financial assets. The transferred financial assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented. For multiple step transfers, a bankruptcy-remote entity is not considered a consolidated affiliate for purposes of performing the isolation analysis. Notwithstanding the isolation analysis, each entity involved in the transfer is subject to the applicable guidance on whether it must be consolidated (see paragraphs 860-10-40-7 through 40-14 and the guidance beginning in paragraph 860-10-55-18). A set-off right is not an impediment to meeting the isolation condition.

b. [EY note: Condition omitted; see Chapter 4, Criteria for a sale – Right to pledge or exchange]

c. [EY note: Condition omitted; see Chapter 5, Criteria for a sale – Effective control]

Legal isolation is one of the criteria for a transfer of financial assets to achieve sale accounting due to its importance to credit rating agencies and investors in securitization transactions. If the transferred financial assets are not legally isolated from the transferor, they could be reclaimed by the receiver in the event of the transferor’s bankruptcy or receivership, increasing the risks that the investors will not receive all of the benefits associated with the transferred financial assets. Accordingly, credit rating agencies and investors commonly demand transaction structures that minimize these risks.

ASC 860’s provisions require that, in order for a transfer to be accounted for as a sale, the assets must be legally isolated from the transferor such that they could not be reacquired by the transferor’s creditors, even in the event of the transferor’s bankruptcy or other receivership. The legal isolation test is applicable to all transfers of financial assets within the scope of ASC 860. The probability of the transferor’s bankruptcy is not relevant. Because the transfer must meet all of the conditions in ASC 860-10-40-5 throughout the life of the assets in order to be accounted for as a sale, the legal isolation test is an ongoing one.
3.2 Legal isolation and supporting evidence

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Isolation of Transferred Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-10-40</td>
</tr>
</tbody>
</table>

40-7 The guidance in the following paragraphs and the related implementation guidance beginning in paragraph 860-10-55-18 applies to transfers by all entities, including institutions for which the Federal Deposit Insurance Corporation (FDIC) would be the receiver.

40-8 Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements being presented and its creditors (see paragraph 860-10-55-23(c)).

40-9 The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated – put presumptively beyond the reach of the transferor, any of its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements being presented, and its creditors, either by a single transaction or a series of transactions taken as a whole – depend on the facts and circumstances.

40-10 All available evidence that either supports or questions an assertion shall be considered, including whether the contract or circumstances permit the transferor to revoke the transfer. It also may include consideration of the legal consequences of the transfer in the jurisdiction in which bankruptcy or other receivership would take place, including all of the following:

a. Whether a transfer of financial assets would likely be deemed a true sale at law (see paragraph 860-10-55-18A) or otherwise isolated (see paragraph 860-10-55-18B)

b. Whether the transferor is affiliated with the transferee

c. Other factors pertinent under applicable law.

40-11 The requirement of paragraph 860-10-40-5(a) that transferred financial assets be isolated focuses on whether transferred financial assets would be isolated from the transferor in the event of bankruptcy or other receivership regardless of how remote or probable bankruptcy or other receivership is at the date of transfer. That is, the requirement would not be satisfied simply because the likelihood of bankruptcy of the transferor is determined to be remote.

40-12 A transferor’s power to require the return of the transferred financial assets arising solely from a contract with the transferee, for example, a call option or removal-of-accounts provision, would not necessarily preclude a conclusion that transferred financial assets have been isolated from the transferor. However, such a power might preclude sale treatment if through it the transferor maintains effective control over the transferred financial assets. Some common financial transactions, for example, typical repurchase agreements and securities lending transactions, may isolate transferred financial assets from the transferor, although they may not meet the other conditions for surrender of control (see paragraph 860-10-40-5).
The nature and extent of the evidence to support the legal isolation assertion depends on the facts and circumstances of each transaction. Derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transfer of the financial assets would be considered legally isolated (i.e., a true sale at law) beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor and its consolidated affiliates (affiliates that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors. When the transfer involves securitization or an asset-backed financing transaction, an assessment of legal isolation would also include an opinion as to whether a bankruptcy court or receiver would substantively consolidate the securitization entity (e.g., trusts, LLCs, etc.) with the transferor from a legal perspective. Thus, a determination of whether the legal isolation criterion has been met to support a conclusion about surrender of control is largely a matter of law and needs to be assessed primarily from a legal perspective.

Whenever the transferor has continuing involvement with the transferred financial assets or the transferee, a legal opinion from a specialist is often required to support this assessment. When a legal opinion is required, the transferor and its auditor must first assess the qualifications of the attorneys involved and determine that they are experts in bankruptcy law or other receivership (e.g., FDIC), as applicable. In addition, the transferor and its auditor must be authorized to use the opinion as evidential matter in support of the evaluation of the transferor’s assertion that the transfer meets the legal isolation criterion of ASC 860. Permission to use the opinion should be provided directly in the legal opinion addressed to the transferor, or in a separate authorization letter in connection with providing a legal opinion to the transferor.

The standards for use of a legal opinion as evidence to support the legal isolation criterion of ASC 860 are contained in Auditing Interpretation 9336, *Using the Work of a Specialist: Auditing Interpretation of Section 336 (AU 9336).* Paragraph 7 of AU 9336 requires the auditor to obtain persuasive evidence that the legal isolation criterion has been met not only at the inception of the transfer of the financial assets, but also in subsequent periods. That is, periodic updates are required to support the transferor’s assertion that the financial assets have been legally isolated and to confirm that there have been no subsequent changes in relevant laws or applicable regulations that may affect the conclusions reached in the previous opinion.

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10 The AICPA Auditing Standards Board is in the process of revising AU 9336 to address, among other things, the FDIC’s new safe harbor for financial assets transferred in connection with securitizations and participations and practice issues that have developed since the audit guidance was first issued in December 2001. Readers should monitor developments in this area.
Excerpt from Accounting Standards Codification

Isolation of Transferred Assets

860-10-55

55-18 This implementation guidance addresses the isolation condition in paragraph 860-10-40-5(a) and applies to transfers of all entities, including institutions for which the FDIC would be the receiver.

55-18A In the context of U.S. bankruptcy laws, a true sale opinion from an attorney is often required to support a conclusion that transferred financial assets are isolated from the transferor, any of its consolidated affiliates included in the financial statements being presented, and its creditors. In addition, a nonconsolidation opinion is often required if the transfer is to an affiliated entity. In the context of U.S. bankruptcy laws:

a. A true sale opinion is an attorney’s conclusion that the transferred financial assets have been sold and are beyond the reach of the transferor’s creditors and that a court would conclude that the transferred financial assets would not be included in the transferor’s bankruptcy estate.

b. A nonconsolidation opinion is an attorney’s conclusion that a court would recognize that an entity holding the transferred financial assets exists separately from the transferor. Additionally, a nonconsolidation opinion is an attorney’s conclusion that a court would not order the substantive consolidation of the assets and liabilities of the entity holding the transferred financial assets and the assets and liabilities of the transferor (and its consolidated affiliates included in the financial statements being presented) in the event of the transferor’s bankruptcy or receivership.

55-18B A legal opinion may not be required if a transferor has a reasonable basis to conclude that the appropriate legal opinion(s) would be given if requested. For example, the transferor might reach a conclusion without consulting an attorney if either of the following conditions exists:

a. The transfer is a routine transfer of financial assets that does not result in any continuing involvement by the transferor.

b. The transferor had experience with other transfers with similar facts and circumstances under the same applicable laws and regulations.

55-18C For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures (for example, banks subject to receivership by the Federal Deposit Insurance Corporation [FDIC]) in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated shall be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.

3.2.1 True sale opinion

Generally, when the transferor retains some form of continuing involvement (e.g., recourse) in the transferred financial assets, a true-sale-at-law opinion from a qualified bankruptcy attorney is frequently obtained to support the conclusion that the transferred financial assets have been legally isolated – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy.

In assessing a true sale at law, attorneys will consider, among other matters:

- Recourse to the transferor
- Intention of the parties
- Economics of the transaction, including adequacy of consideration
- Whether or not the transfer is irrevocable
Criteria for a sale – Legal isolation

- Whether the transferee will bear ultimate credit risk of the transferred financial assets
- Whether a creditor or prospective creditor would be misled as to the nature of the transactions

Typically, recourse is the single most important factor in determining whether a transfer of financial assets is a true sale at law. However, a transferor is not necessarily required to have limited or no recourse in the transferred financial assets to be considered a true sale at law.

3.2.2 Substantive nonconsolidation opinion

Although a true-sale-at-law opinion provides support that the transferred financial assets have been legally isolated from the transferor, if the transferred financial assets can be substantively consolidated into the bankruptcy estate of the transferor, the financial assets are not considered isolated under ASC 860.

Substantive consolidation is a concept that is not explicitly provided by the US Bankruptcy Code. Rather, it is a bankruptcy concept that comes from “federal common law,” permitting a bankruptcy court to treat a group of affiliated entities as if they are one, merging their assets and liabilities for purposes of the bankruptcy proceeding. This concept even allows the court to merge affiliates that have not filed for bankruptcy with the affiliates that have if the court finds that substantive consolidation is required. For example, the risk in a securitization transaction is that the financial assets transferred to the securitization entity will be consolidated with the assets of an insolvent transferor and the third-party beneficial interest holders will be considered creditors of the combined entity. In this case, the creditors of the transferor could recover some benefit from the securitized assets to the detriment of the beneficial interest holders.

The power to order substantive consolidation is derived from the jurisdiction of the bankruptcy court, and the issue is determined on a case-by-case basis. As a general matter, the assets and liabilities of separate entities are not consolidated in insolvency proceedings. If the affairs of two or more entities are so intertwined that it would be impossible or very difficult to separate their assets and/or their liabilities, a court can order that the assets and liabilities be substantively consolidated. Courts will not order consolidation unless it is clear that doing so will not prejudice the creditors of one of the entities unfairly. Generally, the court must be satisfied that substantive consolidation will benefit the creditors of all of the entities as a whole.

Under the substantive consolidation doctrine, if a wholly-owned entity meets certain conditions, it typically would not be legally consolidated with its parent in a bankruptcy proceeding, even though it may be wholly owned and consolidated for financial reporting purposes. Such an entity is commonly referred to as a bankruptcy-remote entity. Although the characteristics of a bankruptcy-remote entity may vary among different jurisdictions, such an entity will generally possess the following characteristics to be considered an entity that is legally separate from its parent:

- Observes corporate formalities
- Has at least one independent director on its board of directors
- Holds itself out as a legal entity separate and distinct from the transferor
- Conducts its activities separate from those of the transferor
- Does not commingle its assets with those of its parent or related affiliates (the transferor)
- Pays its own liabilities with its own funds (i.e., it does not use the funds of its parent to satisfy its obligations)
- Maintains books and records separate from the transferor
- Maintains bank accounts separate from the transferor
3.3 Legal isolation and securitization transactions

Although the concept of legal isolation applies to all transfers of financial assets, it was included as one of the criteria for a financial asset transfer to be accounted for as a sale in large part due to considerations associated with securitization transactions. Legal isolation of transferred financial assets in securitization transactions depends on the structure of the securitization transaction taken as a whole, including the level of continuing involvement of the transferor, the availability of other assets and the powers of bankruptcy courts or other receivers. This section focuses on how the structure of a securitization can affect the assessment of legal isolation.

Securitization transactions are generally accomplished through a single transfer (single-step) or two transfers (two-step). The following diagrams illustrate these two securitization structures:

**Single-step securitization**

- **Transferor** transfers financial assets (e.g., mortgage loans) to a securitization entity (e.g., Trust).
- The securitization entity issues asset-backed securities (Beneficial interests) and remits proceeds back to the transferor.
- The securitization entity transfers the asset-backed securities to investors.

**Diagram note:**
In the single-step securitization diagram, the assets are transferred to a securitization entity (e.g., Trust) that sells an asset-backed security directly to investors. The proceeds from the sale of the asset-backed security are remitted back to the transferor. If the transferor held any beneficial interests created in the transaction or had any other form of continuing involvement with the transferred financial assets, it would be difficult to obtain reasonable assurance that the transferred financial assets were legally isolated from the transferor.

**Two-step securitization**

- In the two-step securitization diagram, the transferor transfers the financial assets to a wholly-owned bankruptcy-remote entity.
- The bankruptcy-remote entity then transfers the financial assets to a securitization entity (e.g., Trust) that issues asset-backed securities to investors for cash. The bankruptcy-remote entity would typically receive as proceeds a subordinated beneficial interest in the assets transferred to the securitization entity (e.g., trust), representing the credit enhancement offered to investors in the transaction. The cash received from investors would be passed back through the structure to the transferor with the bankruptcy-remote entity holding the subordinated beneficial interest as its only asset. The transferor would hold an intercompany receivable or equity interest from the bankruptcy-remote entity equal to the difference between the proceeds received and the value of the assets transferred. In consolidation, the intercompany receivable or equity interest would eliminate with the transferor reporting the subordinated beneficial interest and the cash proceeds from the transaction (assuming there are no other beneficial interests to record).
3.3.1 Single-step securitization

In a single-step securitization, which is explained in ASC 860-10-55-19, an entity transfers financial assets to a securitization entity (corporation or trust) in exchange for cash. If there is no continuing involvement by the transferor, there exists reasonable assurance that the transfer would be judged a true legal sale, effectively placing the assets beyond the reach of the transferor and its creditors. For example, legal isolation might occur if a securitization entity issues beneficial interests only to third-party investors for cash, which is given to the transferor in exchange for the transferred financial assets. That is, the transferor receives only cash as proceeds (i.e., no beneficial interests, servicing rights, etc.) and has no further involvement with the securitization entity or the transferred financial assets subsequent to the transfer date.

While this simple structure would generally achieve the legal isolation criterion of ASC 860-10-40-5(a), from a business perspective, it may not result in a security investors would find attractive. Generally, investors seek some form of protection from credit or interest rate risk – elements of continuing involvement often provided or assumed by the transferor that may make it less certain whether the legal isolation requirement of ASC 860 has been met.

Consider a transfer of a group of entire financial assets to a securitization entity in exchange for cash and a junior beneficial interest (i.e., an interest that absorbs initial credit losses) in the transferred financial assets. The securitization entity raises cash by issuing commercial paper to investors granting them a senior beneficial interest (e.g., a credit enhanced interest) in any cash received from the financial assets. In this example, the transferor maintains continuing involvement with the transferred financial assets by providing credit loss protection to the holders of the senior interest in exchange for a lower cost of the transaction. This continuing involvement by the transferor could make it difficult to obtain reasonable assurance that the transfer would be found to be a true legal sale.

ASC 860-10-55-21 indicates that, depending on facts and circumstances, this latter example of a single-step securitization often would be judged in the US as not having legally isolated the assets from the transferor or its creditors in a US bankruptcy. Many single-step transactions continue to allow rights of redemption that could be exercised by the transferor, receiver or other creditors under certain circumstances. Under such rights, the transferred financial assets are subject to being reclaimed by the transferor, trustee, receiver or other creditor by paying principal and interest earned (at the contractual yield) to the date investors are paid.

The FASB has indicated that such rights are inconsistent with the legal isolation requirements of ASC 860 because if the assets could be reclaimed under such a right and investors were paid only principal and interest through the payment date, the investors would not be compensated for the fair value of their investment on that date. We understand that unless a structure isolates against the right of redemption, single-step transfers with the transferor’s continuing involvement in the transferred financial assets typically will not legally isolate assets of entities subject to the US Bankruptcy Code or other receivership laws in the manner required by ASC 860. This issue should also be carefully considered in transactions completed in foreign jurisdictions.
Two-step securitization

A two-step securitization uses two transfers to both isolate transferred financial assets from the transferor and its creditors, while also providing a credit-enhanced interest for investors (see the diagram in section 3.3). Typical two-step structures are constructed as follows:\(^{11}\)

- First, the transferor transfers a group of entire financial assets to a securitization entity that, although wholly-owned, is designed so that the possibility is remote that the transferor, its other consolidated affiliates included in the financial statements being presented, or its creditors could reclaim the financial assets (i.e., a bankruptcy-remote entity). This first step is designed to be judged a true sale at law, in part because the transferor does not provide “excessive” credit protection. In addition, the bankruptcy-remote entity typically has a board of directors that is independent of the transferor and is not permitted by its charter to undertake any other business or to incur any liabilities. Its dedication to a single transaction and the other circumstances surrounding it make it extremely unlikely that it would enter bankruptcy and, even if it did, that a receiver could reclaim the transferred financial assets. This transfer is intended to legally isolate the transferred financial assets from the transferor.

- Second, the bankruptcy-remote entity transfers the group of entire financial assets to a securitization entity (e.g., a trust or other type of legal entity) and provides the credit enhancement necessary to obtain the high credit rating sought by third-party investors on their interests (e.g., beneficial interests or asset-backed securities). The credit enhancement is provided by the bankruptcy-remote entity's junior (subordinated) beneficial interest in the transferred financial assets or other means. Because of the credit enhancement provided in the second transfer, it might not be judged to be a true sale at law. Thus, the bankruptcy trustee for the bankruptcy-remote entity could, at least in theory, reach the transferred financial assets. However, the transaction has been designed to make remote the possibility that the bankruptcy-remote entity would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of the original transferor, should that occur.

A true sale and a substantive nonconsolidation opinion are generally required for the first step in a two-step securitization. This legal determination requires consideration of the transactions taken as a whole.

ASC 860-10-55-22 states that two-step securitizations, taken as a whole, generally would be judged under present US law as having isolated the financial assets beyond the reach of the transferor, its consolidated affiliates (that are not bankruptcy-remote entities) included in the financial statements presented, and its creditors, even in bankruptcy or other receivership. However, even if the transaction is structured as described, the determination of whether the financial assets are legally isolated from the transferor is a legal determination that is based on the individual facts and circumstances.

Other considerations

A bankruptcy-remote entity in a two-step securitization transaction is not necessarily required to account for the second step transfer as a secured borrowing when, as typically occurs, the bankruptcy-remote entity is not able to obtain a true sale opinion for its transfer of financial assets to the securitization entity. Despite the lack of legal isolation between the bankruptcy-remote entity, and the securitization entity, the consolidated entity should account for the second step transfer as a sale when each of the following conditions is met:

- The transferor has obtained a true sale and substantive nonconsolidation opinion for the transfer to the bankruptcy-remote entity (i.e., step one in the two-step transfer described above).

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\(^{11}\) The description of the two-step structures designed to achieve legal isolation is based on implementation guidance provided in ASC 860-10-55-23.
The transferor has obtained a substantive nonconsolidation opinion regarding the securitization entity (assuming the securitization entity is deemed to be an affiliate).

Neither the transferor nor its consolidated bankruptcy-remote entity is required to consolidate the securitization entity in accordance with applicable consolidation accounting guidance (i.e., ASC 810, Consolidation).

3.4 Considerations when reviewing legal opinions

The following are common practice issues to consider when determining whether a legal opinion provides adequate support that the transferred financial assets are legally isolated. These issues are not all inclusive.

3.4.1 Instructions to perform additional analysis

Limitations in the legal opinion could negate an otherwise satisfactory opinion by instructing the reader (user) to perform additional legal analysis of the factors mentioned, thereby implying that those factors have not been considered by the legal specialist in forming his/her opinion. For example, the following limitation would generally preclude reliance on the legal opinion:

“We note that legal opinions on bankruptcy law matters unavoidably have inherent limitations that generally do not exist in respect of other legal issues on which opinions to third parties are typically given. These inherent limitations exist primarily because of the pervasive powers of bankruptcy courts and other factors. The recipients of this opinion should take these limitations into account in analyzing the bankruptcy risk associated with the transactions as contemplated by the agreements.”

3.4.2 Assumptions regarding accounting treatment

Legal opinions sometimes include an assumption that the transaction qualifies for sale accounting treatment under the criteria of ASC 860. This assumption is circular and is not appropriate because one of the criteria for the transfer to be considered a sale is that the transferred financial asset is legally isolated. Since the legal opinion is required to satisfy this criterion, it is not appropriate for the legal opinion to include this assumption. If this type of language is included in a legal opinion, the assumption should specifically exclude the legal isolation criterion of ASC 860-10-40-5(a).

3.4.3 Right of redemption

An opinion may acknowledge the ability by the transferor or its creditors, under certain circumstances, to reacquire the transferred financial assets by paying the original purchase price plus interest. While the FASB provided limited relief with respect to this issue for certain regulated entities (e.g., insured depository institutions subject to the special powers of the FDIC and other similar entities that may not be subject to the US Bankruptcy Code; see section 3.5 for additional information about such circumstances), such provisions are generally not sufficient to support the legal isolation criteria of ASC 860-10-40-5(a).

3.4.4 Repurchase agreements

Repurchase agreements often are purported to be both contractual and legal sales to the repurchase agreement counterparty. However, as described in ASC 860-10-40-42, an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (linked transaction) unless (a) the two transactions have a valid and distinct business or economic purpose for being entered into separately and (b) the repurchase financing does not result in the initial transferor regaining control over the financial asset. In practice, a linked transaction generally would not meet the legal isolation criterion when the seller of financial assets provides financing to the purchaser of the assets in the form of a repurchase agreement collateralized by the same financial assets the seller transferred. An entity considers a repurchase agreement only if it is a linked transaction as described above. Otherwise, the
repurchase agreement is ignored for purposes of assessing whether “all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer”\(^{12}\) have allowed the surrender of control over the transferred financial assets or third-party beneficial interests.

See section 9.7 for additional information about repurchase financing transactions and the specific criteria for determining whether an initial transfer and repurchase financing should be evaluated as a linked transaction.

### 3.4.5 Exclusion of side agreements or related transaction

A legal opinion should explicitly address or contemplate all forms of the reporting entity’s continuing involvement with the transferred financial assets, including any side agreements or related transactions. An example of a side agreement that may not be explicitly considered in the legal opinion (that may cause the transfer not to be accounted for as a sale) is when the parent of, or company affiliated with, the transferor provides the transferee with a guarantee or other recourse, either directly or through arrangements made contemporaneously with, or in contemplation of, the transfer — even if they were not entered into at the time of the transfer.

Additionally, attorneys may explicitly assume side agreements or known transactions with affiliated parties or agents were not present with the transaction. Accordingly, management of the transferor should ensure that the list of applicable documents considered by the attorneys in preparing the legal opinion is complete and that the legal opinion addresses the legal isolation criterion considering all other subsidiaries in a consolidated group, particularly when such subsidiaries have involvement with the assets or are parties to the transaction.

### 3.4.6 “Look back” period for bankruptcy

Qualifying language in the legal opinion may state that the opinion was not applicable to the extent the transferor filed bankruptcy within a certain extended time period after the transfer (or held an assumption that such a filing would not take place). While an assumption with respect to the transferor’s solvency at the time of transfer would be appropriate, provisions that extend beyond the actual transfer date likely lead to a “springing true-sale-at-law opinion.” Such an opinion concludes that the asset is not appropriately isolated until the “look back” period expires.

### 3.4.7 Level of recourse

Qualifying language in some opinions discusses how a court would view the level of recourse, with the legal specialist not providing an opinion with respect to this aspect of the transaction. Retained recourse is a key component considered by legal specialists when rendering their opinions; thus it is usually inappropriate for the opinion to not address this issue.

When recourse provisions are included in the transaction, the transferor’s legal isolation analysis should consider whether the legal specialist has evaluated whether the level of recourse present adversely affects the true sale opinion and substantive nonconsolidation opinion, if applicable. Limited historical information, heterogeneous assets or significant changes in underwriting are a few factors that may cause the legal specialist’s analyses to be more difficult.

\(^{12}\) This requirement related to the determination of whether a transferor and its consolidation affiliates included in the financial statements being presented have surrendered control over transferred financial assets or third-party beneficial interests is included in ASC 860-10-40-4(c).
In legal opinions that address the level of recourse in a given transfer and conclude based on reference to case law as to whether the amount of recourse retained is considered appropriate for sale treatment, care must be taken to ensure that the assumptions used to make this conclusion are consistent with the expected results of the transferred financial assets.

For example, assume that a transferor agrees to provide the transferee recourse for any losses incurred during the first 18 months after the transfer of a group of automobile loans. The transferor estimates that the recourse obligation assumed is only 5% of the transferred assets even though actual losses during this period have historically been around 10% and nothing significantly has changed in the economy, loan structure or customer demographics to support a lower estimate. If the attorney’s opinion letter concludes that the level of recourse obligation retained by the transferor (i.e., 5%) is reasonable, the assumption of 5% upon which the opinion is based would be inconsistent with the expected future losses of 10%.

### 3.4.8 Requirement to notify underlying debtors

Legal opinions may contain assumptions that notification of the transaction has been made to the debtors when in fact the parties do not intend to notify the debtors. In some transfers, notification to the borrower that its loan has been sold to a third party will be a requirement for a true sale, particularly under the laws of certain foreign countries. In these cases, legal title to the loan will transfer only upon notification. Some countries’ laws require that each borrower be notified directly, while other countries’ laws require only that the transfer be included in a registry. Typically, the legal opinion will assume notification when required by applicable law. The transferor should determine that notification has occurred (and continues to occur in revolving transactions), if required by the applicable jurisdiction, prior to concluding a transfer meets the criteria to be accounted for as a sale.

### 3.4.9 Inconsistency with tax treatment

Assumptions of the tax analysis and the legal sale analysis should be compared to determine whether they conflict. In addition to raising a question regarding the fair value used for US GAAP reporting purposes, different fair values ascribed to the loans sold and/or interests retained for tax reporting may challenge the validity of a legal opinion assumption about the appropriateness of the consideration paid for the assets transferred.

### 3.4.10 Foreign jurisdictions

Achieving the legal isolation criterion when the transaction occurs in a foreign market is even more complex. It is important to remember that the legal isolation requirement is the same (i.e., the assets must be legally isolated from the transferor and any of its consolidated affiliates included in the financial statements being presented, even in the event of bankruptcy or other receivership or the applicable jurisdiction’s equivalent). However, the language in the legal opinion supporting legal isolation may differ due to the difference in legal environments in various countries. In addition, the transferor should consider the need to receive a legal opinion in each country in which assets may have originated for transactions involving global transfers of financial assets.

The effect of a recourse provision on the legal isolation criteria of ASC 860 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred financial assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. Legal isolation may need to be assessed either in the jurisdiction in which assets were originated, in which they were transferred, or both.
3.4.11 Set-off rights

A set-off right is a common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation. The existence of set-off rights is not considered by a court when assessing whether a transaction would be deemed to be a true sale. In the event of bankruptcy or receivership of either the obligor of the financial asset or the transferor of the financial asset, both parties could retain the ability to exercise a set-off right involving a financial asset that had been transferred. In the event of the bankruptcy of the transferor, the transferee may have only an unsecured claim against the transferor for its share of the amount of set off.

For example, assume that a transferor originates a loan for $10,000 and transfers a 20% participating interest in the loan to a third party. In addition, assume that the original obligor (i.e., the borrower of the $10,000 loan from the transferor) has a deposit with the transferor of $10,000. The loan and the deposit are subject to set-off rights. If the transferor entered bankruptcy and did not pay to settle its customer deposit, the original obligor (depositor) would be able to set off its deposit with the transferor against the $10,000 loan and would not be required to make any further payments to the transferor. In this example, the transferor would not receive cash on the settlement (via set-off) of the loan, but also would not be required to repay the deposit. The set-off causes the third-party transferee to become an unsecured creditor of the transferor.

The FASB considered whether set-off rights related to a transferred financial asset should be severed to meet the legal isolation requirements, but learned that it may not be possible to sever them. For example, certain consumer protection laws prevent consumers from waiving their ability to exercise set-off rights against a seller of goods financed under a contract with the seller. In other cases, it may be impractical or infeasible for a transferor to sever set-off rights related to transferred financial assets because doing so would require the involvement of an obligor on the original financial assets who may not even be aware of or otherwise involved in the transfer.

Attorneys told the FASB that a court likely would compel a transferor that benefited from an exercise of set-off rights on a transferred financial asset to pass through a proportionate share of that benefit to any transferee that held a share of the related original financial asset. Constituents also told the FASB that set-off risks are assessed and included in the price for the transaction like other dilutive risks, such as warranties and returns. Based on this, the FASB decided that set-off rights would not be an impediment to meeting the isolation requirement.

3.5 Considerations applicable for entities not subject to the US Bankruptcy Code

Excerpt from Accounting Standards Codification

Isolation of Transferred Assets

860-10-55

55-24 The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the Federal Deposit Insurance Corporation (FDIC)) vary considerably, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred financial assets from a transferor subject to such a receiver and its creditors even though it is accomplished by only one transfer directly to a securitization entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.
Depending on the facts and circumstances, transferred financial assets can be isolated from the transferor if the Federal Deposit Insurance Corporation (FDIC) would be the receiver should the transferor fail. In July 2000, the FDIC adopted a final rule, *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*. The final rule modifies the FDIC’s receivership powers so that, subject to certain conditions, it shall not recover, reclaim, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution that meet all conditions for sale accounting treatment under GAAP, other than the legal isolation condition in connection with a securitization or participation.\[^{13}\]

Financial assets transferred by an entity subject to possible receivership by the FDIC are isolated from the transferor if the FDIC or another creditor either cannot require return of the transferred financial assets or can only require return in receivership, after a default, and in exchange for payment of, at a minimum, principal and interest earned (at the contractual yield) to the date investors are paid.

Conversely, financial assets transferred by an entity shall not be considered isolated from the transferor if circumstances can arise under which the transferor can require their return, but only in exchange for payment of principal and interest earned (at the contractual yield) to the date investors are paid, unless the transferor’s power to require the return of the transferred financial assets arises solely from a contract with the transferee. A noncontractual power to require the return of transferred assets is inconsistent with the limitations in paragraph 860-10-40-5(a) that, to be accounted for as having been sold, transferred financial assets shall be isolated from the transferor. That is the circumstance even if the noncontractual power appears unlikely to be exercised or is dependent on the uncertain future actions of other entities (for example, insufficiency of collections on underlying transferred financial assets or determinations by court of law). Under that guidance, a single-step securitization commonly used by financial institutions subject to receivership by the FDIC and sometimes used by other entities is likely not to be judged as having isolated the assets. One reason for that is because it would be difficult to obtain reasonable assurance that the transferor would be unable to recover the transferred financial assets under the equitable right of redemption available to secured debtors, after default, under U.S. law.

For entities that are subject to possible receivership under jurisdictions other than the FDIC or the U.S. Bankruptcy Code, whether assets transferred by an entity can be considered isolated from the transferor depends on the circumstances that apply to those types of entities. As discussed in paragraph 860-10-55-24, for entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred financial assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions. The same sorts of judgments may need to be made in relation to powers of the transferor or its creditors.

### 3.5.1 Insured depository institutions and similar entities

Since 2000, the Federal Depository Insurance Corporation (FDIC) has clarified that it would not exercise its statutory power to disaffirm or repudiate contracts to reclaim any of an insured depository institution’s (IDI) financial assets transferred in connection with a securitization or participation in the receivership or conservatorship of an IDI provided the IDI’s transfers met certain conditions, including the conditions for sale accounting under US GAAP.

\[^{13}\] EY note: Refer to section 3.5.1 for a discussion on the FDIC’s amendments to its safe harbor rule.
The FDIC’s legal isolation safe harbor has been relied on by securitization participants as assurance that investors could look to securitized financial assets for payment without concern that the financial assets would be interfered with by the FDIC as conservator or receiver.

However, the implementation of ASU 2009-16 and ASU 2009-17 for transfers of financial assets and consolidation of variable interest entities (e.g., special-purpose vehicles), respectively, have resulted in more securitizations to be accounted for as secured borrowings and has created uncertainty for securitization participants (because sale accounting is a precondition for the FDIC’s safe harbor).

In response to market concerns over the accounting changes, on 27 September 2010, the FDIC adopted an amended safe harbor rule (the Final Rule\(^\text{14}\)). The Final Rule continues the legal isolation safe harbor for financial assets transferred in compliance with previous FDIC rules (including the Interim Final Rule\(^\text{15}\) of November 2009). Additionally, it modifies the original safe harbor provisions in two significant ways:

- It establishes two types of safe harbors for securitizations and participations depending on whether the transactions are accounted for as sales or secured borrowings under ASC 860 (previously, only transfers that met the conditions for sale accounting under US GAAP qualified for the FDIC’s safe harbor)
- It establishes new conditions, including new disclosure and risk retention requirements, for a securitization to qualify for either safe harbor

In order to ensure that the Final Rule fully conforms with the risk retention regulations required by the Dodd-Frank Act,\(^\text{16}\) the FDIC’s new safe harbor rule provides that, upon adoption of those interagency regulations, those final regulations shall exclusively govern the risk retention requirement in the safe harbor regulation.

The audit guidance in AU 9336 provides two alternate forms of legal opinions that are acceptable for transferors subject to receivership or conservatorship under the provisions of the Federal Deposit Insurance Act (FDIA). Either a “true sale” opinion similar to opinions provided to non-FDIC insured transferors or an opinion addressing isolation both prior to the appointment of the FDIC as a receiver and following the appointment of the FDIC as receiver may be obtained. Additionally, the opinion must address the doctrine of “substantive consolidation” when the entity to which the financial assets are transferred is an affiliate of the selling entity (e.g., to a bankruptcy-remote entity in a two-step transaction) and in other situations as noted by a legal specialist. In all cases, the appropriate jurisdiction’s laws should be considered. See question 3-9 for additional guidance.

### 3.5.2 Entities subject to US state insurance regulations

In the event of an insurance company’s insolvency, we understand that certain US state insurance regulatory agencies may hold certain receivership rights. Similar to insured depository institutions and other entities not subject to the bankruptcy code, the attorney’s true-sale-at-law opinion should address such considerations for a transferor that is regulated by US state insurance regulations. The legal isolation assessment should also address the doctrine of “substantive consolidation” in these circumstances.

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\(^\text{15}\) FDIC proposed Interim Final Rule; http://www.fdic.gov/news/board/2009nov12no6.pdf. The transitional safe harbor provisions of the Interim Rule, which were ultimately extended by the Final Rule, confirms that participations and securitizations completed (or currently in process) on or before 31 December 2010 in reliance on the FDIC’s existing regulation will be “grandfathered” and continually protected by the safe harbor, so long as those participations or securitizations comply with US GAAP in effect prior to 15 November 2009 (i.e., ASC 860, prior to its amendment by Statement 166).

\(^\text{16}\) The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which was signed into law on 21 July 2010.
Questions and interpretive responses

Legal isolation and the use of legal opinions

Question 3-1  Use of legal opinions for routine transfers of financial assets

What factors should be considered in evaluating the need for a legal opinion for “routine” transfers of financial assets? Can a transferor rely on a legal conclusion reached in a previous transfer if the underlying circumstances are similar?

The nature and extent of evidence to support the legal isolation criterion depends on the facts and circumstances of each transaction.

In evaluating whether a new or updated legal opinion is necessary for routine transfers, a transferor could consider its experience with similar transactions. For example, a transferor might conclude that financial assets are legally isolated if a legal opinion were obtained in connection with a previous transaction that involved the same asset types and key transaction terms and under the same applicable laws and regulations as the transaction being evaluated currently. Indicators that a new or updated legal opinion may be required include (but are not limited to):

› Lockbox arrangements have not been made in the transferee’s name to legally segregate the cash receipts from customers from the transferor/servicer’s cash (i.e., the transferor’s and transferee’s assets are commingled).

› The underlying borrowers have not been notified that their loans have been transferred.

› A history of more than infrequent and insignificant representation and warranty violations might indicate the underwriting process is flawed and sale recognition is not appropriate.

› Recourse is provided by the transferor/servicer with respect to the asset performance. A common example of recourse in otherwise routine transactions includes a default put that allows the transferee to put back (return) loans in default to the transferor for a fixed price (usually par value plus accrued interest). Default terms are specified in the transaction documents and commonly include the debtor missing one or more payments, or failing certain liquidity measures, among other events. When recourse is present, we believe a legal opinion is typically necessary to support management’s assertion.

Question 3-2  Obtaining a legal opinion

Should it be assumed that the transferred financial assets are not legally isolated if a legal opinion is not obtained?

We believe the transferor should evaluate the legal isolation criteria as part of each transfer and not default to accounting for the transfer as a secured borrowing without determining whether the transferred financial assets have been sold. In the event that the transferor does not obtain a required legal opinion, the independent auditor may be required to express a qualified opinion or disclaim an opinion because of the scope limitation.
Question 3-3  
**Legal opinions prepared by internal counsel**

Is a legal opinion prepared by internal counsel adequate support for management’s assertion that the transferred financial assets are legally isolated?

Typically, an opinion from external counsel will be necessary, particularly if external counsel provided opinions to other transaction participants, such as underwriters or rating agencies. The use of opinions from internal counsel would be appropriate only when the transferor can provide proper support that internal counsel has appropriate credentials to render such an opinion given their experience in transactions of the type being addressed as well as the applicable bankruptcy or receivership law.

Question 3-4  
**Evaluating the legal isolation condition when likelihood of bankruptcy is remote**

Is the legal isolation requirement of ASC 860-10-40-5(a) satisfied if the likelihood of bankruptcy is remote?

No. The requirement of ASC 860-10-40-5(a) focuses on whether transferred financial assets would be isolated from the transferor in the event of bankruptcy or other receivership, regardless of how remote or probable bankruptcy or other receivership is at the date of transfer.

Question 3-5  
**Evaluating legal isolation at the level of the financial statement being presented**

Could transferred financial assets be considered legally isolated for purposes of a subsidiary’s stand-alone financial statements but not legally isolated in its parent’s consolidated financial statements?

ASC 860 requires that the accounting for transfers of financial assets be determined at the level of the financial statements being presented. Accordingly, a transfer may be accounted for as a sale in the transferor’s stand-alone financial statements but as a secured borrowing in its parent’s consolidated financial statements.

To illustrate, assume a transferor transfers financial assets to a third-party entity and obtains cash and a subordinated interest as proceeds. Simultaneously, the transferor’s consolidated subsidiary provides servicing for the transferred financial assets and the transferor’s parent provides a limited recourse guarantee on the performance of the transferred assets.

The subordinated interest, the servicing contract and limited recourse guarantee are all forms of involvement with the transferred assets that should be considered in the separate legal isolation analyses to evaluate whether the assets are legally isolated for purposes of (1) the transferor’s stand-alone (consolidated) financial statements and (2) its parent’s consolidated financial statements. Because of the potential for different legal isolation conclusions, the transfer could be required to be accounted for as a sale in the transferor’s stand-alone financial statements, but as a secured borrowing in its parent’s consolidated financial statements.

Question 3-6  
**Legal conclusion that a sale occurred**

Should a transfer automatically be accounted for as a sale if a true sale legal opinion is obtained?

In order for a transfer of financial assets to be accounted for as a sale, all of the criteria in ASC 860-10-40-5 must be met. ASC 860-10-40-5(a) contains the legal isolation requirements, but the transferee’s right to pledge or exchange in ASC 860-10-40-5(b) and the transferor’s surrender of effective control in ASC 860-10-40-5(c) must also be evaluated prior to concluding the transfer should be accounted for as a sale.
Considerations when reviewing legal opinions

**Question 3-7**  
Legal opinions providing persuasive evidence

Is there specific language that should be included in the legal opinion to provide persuasive evidence that the transferred financial assets are legally isolated for an entity subject to the US Bankruptcy Code?

Paragraph 12 of AU 9336 provides an example of the conclusions in a legal opinion for an entity that is subject to the US Bankruptcy Code that provides persuasive evidence, in the absence of contradictory evidence, to support management’s assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in bankruptcy or other receivership:

“We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller's estate for purposes of [the relevant sections] of the US Bankruptcy Code."

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist.

“Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a proceeding under the US Bankruptcy Code, (footnote reference omitted) in which the Seller is a Debtor, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller in a case involving the insolvency of the Seller under the doctrine of substantive consolidation.”

**Question 3-8**  
Legal opinions not providing persuasive evidence

What are some examples of language in opinion conclusions that do not provide persuasive evidence that the transferred financial assets have been legally isolated from the transferor?

Paragraph 15 of AU 9336 provides the following examples of such language:

- “We are unable to express an opinion...”
- “It is our opinion, based upon limited facts...”
- “We are of the view...” or “it appears...”
- “There is a reasonable basis to conclude that...”
- “In our opinion, the transfer would either be a sale or a grant of a perfected security interest...” (footnote reference omitted)
- “In our opinion, there is a reasonable possibility...”
- “In our opinion, the transfer should be considered a sale...”
Criteria for a sale — Legal isolation

- “It is our opinion that the company will be able to assert meritorious arguments...”
- “In our opinion, it is more likely than not ...”
- “In our opinion, the transfer would presumptively be...”
- “In our opinion, it is probable that...”

As stated, this language does not provide persuasive evidence that the transferred financial assets have been legally isolated from the transferor and must be replaced with the language in question 3-7 for entities subject to the US Bankruptcy code or question 3-9 for entities subject to FDIC receivership.

Entities subject to FDIC receivership

Question 3-9 Legal opinions for entities subject to FDIC receivership

What legal opinion conclusion language provides persuasive evidence that the transferred financial assets are legally isolated for an entity subject to FDIC receivership?

Paragraph 14 of AU 9336 provides two examples of opinion conclusions (see Illustrations 3-1 and 3-2 below) that provide persuasive evidence, in the absence of contradictory evidence, to support management’s assertion that the transferred financial assets have been put presumptively beyond the reach of the entity and its creditors, even in conservatorship or receivership.17

Illustration 3-1: Standard legal opinion conclusion

“We believe (or it is our opinion) that in a properly presented and argued case, as a legal matter, in the event the Seller were to become subject to receivership or conservatorship, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of, or subject to repudiation, reclamation, recovery, or recharacterization by, the receiver or conservator appointed with respect to the Seller.”

17 Insolvency and receivership laws applicable to depository institutions, and how those laws affect the legal isolation criterion, differ depending upon the nature of the depository institution and its chartering authority. Accordingly, legal opinions addressing the legal isolation criterion may be formulated in different ways to accommodate those differences.

For an entity subject to conservatorship or liquidation under the National Credit Union Act, the sample opinions in Illustrations 3-1 and 3-2 and discussion in this paragraph would be modified to make appropriate references to “liquidation” and “liquidating agent” and additional information relating to rights and regulations of the National Credit Union Administration. Refer to paragraph 14 in AU 9336 for further guidance.
Illustration 3-2: Legal opinion conclusion based on the FDIC’s safe harbor

“The Federal Deposit Insurance Corporation (FDIC) has issued a regulation, ‘Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation,’ 12 CFR section 360.6 (the Rule). Based on and subject to the discussion, assumptions, and qualifications herein, it is our opinion that:

a. Following the appointment of the FDIC as the conservator or receiver for the Bank:
   (i) The Rule will apply to the Transfers,
   (ii) Under the Rule, the FDIC acting as conservator or receiver for the Bank could not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. §1821(e), reclaim or recover the Transferred Assets from the Issuer or recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank,
   (iii) Neither the FDIC (acting for itself as a creditor or as representative of the Bank or its shareholders or creditors) nor any creditor of the Bank would have the right, under any bankruptcy or insolvency law applicable in the conservatorship or receivership of the Bank, to avoid the Transfers, to recover the Transferred Assets, or to require the Transferred Assets to be turned over to the FDIC or such creditor, and
   (iv) There is no other power exercisable by the FDIC as conservator or receiver for the Bank that would permit the FDIC as such conservator or receiver to reclaim or recover the Transferred Assets from the Issuer, or to recharacterize the Transferred Assets as property of the Bank or of the conservatorship or receivership for the Bank; provided, however, that we offer no opinion as to whether, in receivership, the FDIC or any creditor of the Bank may take any such actions if the Holders (holders of beneficial interests in the transferred assets) receive payment of the principal amount of the Interests and the interest earned thereon (at the contractual yield) through the date the Holders are so paid; and

b. Prior to the appointment of the FDIC as conservator or receiver for the Bank, the Bank and its other creditors would not have the right to reclaim or recover the Transferred Assets from the Issuer, except by the exercise of a contractual provision [insert appropriate citation] to require the transfer, or return, of the Transferred Assets that exists solely as a result of the contract between the Bank and the Issuer.”

The following additional paragraph addressing substantive consolidation applies when the entity to which the assets are sold or transferred (as described in the opinion) is an affiliate of the selling entity and may also apply in other situations as noted by the legal specialist (footnote reference omitted).

“Based upon the assumptions of fact and the discussion set forth above, and on a reasoned analysis of analogous case law, we are of the opinion that in a properly presented and argued case, as a legal matter, in a receivership, conservatorship, or liquidation proceeding in respect of the Seller, a court would not grant an order consolidating the assets and liabilities of the Purchaser with those of the Seller.”
4 Criteria for a sale – Right to pledge or exchange

4.1 Overview

This chapter focuses on the second criterion commonly referred to as the “transferee’s right to pledge or exchange” criterion, which requires that each transferee or, if the transferee is a “securitization entity,” each third-party holder of its beneficial interests, has the ability to freely pledge and exchange the transferred financial assets or beneficial interests in order for the transfer to be accounted for as a sale.

Excerpt from Accounting Standards Codification

<table>
<thead>
<tr>
<th>Conditions for a Sale of Financial Assets</th>
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<tbody>
<tr>
<td><strong>860-10-40-5</strong></td>
</tr>
<tr>
<td>A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:</td>
</tr>
<tr>
<td>a. [EY note: Condition omitted; see Chapter 3, Criteria for a sale – Legal isolation]</td>
</tr>
<tr>
<td>b. Transferee’s right to pledge or exchange. This condition is met if both of the following conditions are met:</td>
</tr>
<tr>
<td>1. Each transferee (or, if the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities and that entity is constrained from pledging or exchanging the assets it receives, each third-party holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received.</td>
</tr>
<tr>
<td>2. No condition does both of the following:</td>
</tr>
<tr>
<td>i. Constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its rights to pledge or exchange</td>
</tr>
<tr>
<td>ii. Provides more than a trivial benefit to the transferor (see paragraphs 860-10-40-15 through 40-21.</td>
</tr>
<tr>
<td>If the transferor, its consolidated affiliates included in the financial statements being presented, and its agents have no continuing involvement with the transferred financial assets, the condition under paragraph 860-10-40-5(b) is met.</td>
</tr>
<tr>
<td>c. [EY note: Condition omitted; see Chapter 5, Criteria for a sale – Effective control]</td>
</tr>
</tbody>
</table>

If a transferor retains some form of continuing involvement with the transferred financial asset, to account for the transfer as a sale, ASC 860-10-40-5(b) requires each transferee to have the right to pledge or exchange the financial asset it received, and no condition both constrains the transferee from taking advantage of its right and provides more than a trivial benefit to the transferor.
A constraint may be transferor-imposed or imposed by other parties. Judgment is required to assess whether a particular condition represents a constraint on the transferee and provides a more-than-trivial benefit to the transferor.

The ASC 860-10-40-5(b) criterion also applies to entities whose sole purpose is to engage in securitization or asset-backed financing activities (collectively referred to as securitization entities) when that entity is constrained from pledging or exchanging the transferred asset. In this circumstance, the criterion is applied to the third-party holders of that entity's beneficial interests rather than the transferee of the financial asset. The FASB reasoned a third-party holder's right to pledge or exchange those beneficial interests is the counterpart of a transferee's right to pledge or exchange the transferred assets themselves.

For the remainder of this chapter, when the terms “financial asset” and “transferee” are used, the same principles and guidance would apply to “beneficial interests” and “third-party holders of those beneficial interests” issued by an entity whose sole purpose is to facilitate securitizations or asset-backed financing activities whether or not specifically stated.

### 4.2 Decision tree related to a transferee’s right to pledge or exchange

The following diagram illustrates the process to determine whether the “right to pledge or exchange” condition has been met and the potential effect of that determination.

```
Does the transferor have any continuing involvement with the transferred financial asset?

Yes

Is the transferee constrained from pledging or exchanging the transferred financial asset?

Yes

Does the constraint provide the transferor a more than trivial benefit?

Yes

ASC 860-10-40-5(b) condition not met – the transfer is accounted for as a secured borrowing with a pledge of collateral.

No

No

No

No

ASC 860-10-40-5(b) condition met – the transfer is accounted for as a sale if the other derecognition criteria in ASC 860-10-40-5 are met.
```
4.2.1 Does the transferor have any continuing involvement with the transferred financial asset?

A transferor’s continuing involvement may involve a variety of activities or arrangements and is defined in the ASC Master Glossary as any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer.

When evaluating the existence of continuing involvement, the transferor must also consider the involvement of its consolidated affiliates included in the financial statements being presented and its agents. ASC 860-10-55-79A and 55-79B provide examples of evidence to be considered and examples of continuing involvement.

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>860-10-55</th>
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<tbody>
<tr>
<td>55-79A</td>
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<tr>
<td>a.</td>
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<tr>
<td>b.</td>
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<tr>
<td>c.</td>
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<tr>
<td>55-79B</td>
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<tr>
<td>a.</td>
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<td>e.</td>
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<tr>
<td>f.</td>
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<tr>
<td>g.</td>
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</tbody>
</table>

See questions 4-1 to 4-3 for additional interpretive guidance.

4.2.2 Is the transferee constrained from pledging or exchanging the transferred financial asset?

The party that obtains the economic benefits of the financial asset (primarily the future cash inflows of the financial asset) is the party that generally would be considered to control the financial asset. Consequently, in order to achieve sale accounting, the transferee must be able to obtain the benefits of ownership (i.e., the cash inflows) of the asset either by pledging or exchanging the asset.

Under ASC 860, an entity can generally obtain all or most of the economic benefits (cash flows) from a financial asset either by exchanging the transferred financial asset or by pledging it as collateral. The emphasis in ASC 860-10-40-5(b) regarding such rights focuses on an entity’s ability to obtain all or nearly all of the economic benefits from the financial asset.
Excerpt from Accounting Standards Codification

860-10-40

40-15 Many transferor-imposed or other conditions on a transferee’s right to pledge or exchange both constrain a transferee from pledging or exchanging and, through that constraint, provide more than a trivial benefit to the transferor. Judgment is required to assess whether a particular condition results in a constraint. Judgment also is required to assess whether a constraint provides a more-than-trivial benefit to the transferor. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from pledging or exchanging the transferred financial assets to protect the rights of beneficial interest holders in the financial assets of the entity. Paragraph 860-10-40-5(b) requires that the transferor look through the constrained entity to determine whether each third-party holder of its beneficial interests has the right to pledge or exchange the beneficial interests that it holds. The considerations in paragraphs 860-10-40-16 through 40-18 apply to the transferee or the third-party holders of its beneficial interests in an entity that is constrained from pledging or exchanging the assets it receives and whose sole purpose is to engage in securitization or asset-backed financing activities.

40-16 A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Grants of security interests

The granting of a security interest in a financial asset is not the same as pledging a financial asset. A security interest is defined as a form of interest in property that provides, upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation. In contrast, a pledge transfers custody and legal title of the financial asset to the secured party. Therefore, the condition in ASC 860-10-40-5(b) is not satisfied if the transferee has only a security interest in the financial asset or if the transferee is able to only grant a security interest in the financial asset.

See questions 4-4 and 4-5 for additional interpretive guidance.

4.2.3 Does the constraint provide the transferor a more than trivial benefit?

Excerpt from Accounting Standards Codification

860-10-55-30

For a transfer to fail to meet the condition in paragraph 860-10-40-5(b), the transferee must be constrained from pledging or exchanging the transferred financial asset and the transferor must receive more than a trivial benefit as a result of the constraint.

Determining whether a constraint provides the transferor with more than a trivial benefit is not always clear and often requires significant judgment. The fact that a constraint on a transferee may be explicit or implicit further complicates that judgment. Additionally, the FASB has not defined the concept of “more than a trivial benefit.” However, a key condition in making this determination is whether the transferor is aware of the constraint (see section 4.2.3.1).
4.2.3.1 Transferor imposed and non-transferor imposed conditions that may constrain a transferee

As a general rule, a condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. However, a condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor.

In concept, transferors incur costs if they impose constraints, because transferees presumably pay less than they would to obtain the financial asset without such constraints. Moreover, transferors presumably incur those costs for a substantive business reason. Consequently, the FASB and SEC staff have generally concluded that, absent evidence to the contrary, a condition imposed by a transferor that constrains the transferee presumptively results in a more-than-trivial benefit to the transferor.

However, it is less clear whether conditions not imposed by the transferor constrain the transferee and provide a more-than-trivial benefit to the transferor. ASC 860-10-40-16 states that a condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint.

When determining whether the requirements of ASC 860-10-40-5(b) have been met, entities should consider all relevant facts and circumstances. In practice, it is difficult for a transferor with continuing involvement to overcome the “more than trivial benefit” presumption when the constraint is either imposed by the transferor or imposed by a third party of which the transferor is knowledgeable.

4.3 Examples of conditions that presumptively constrain the transferee

While each condition that constrains a transferee from pledging or exchanging the transferred financial asset should be assessed, not every constraint provides more than a trivial benefit to the transferor. ASC 860-10-40-19 states that judgment is required to assess the significance of some conditions. Examples of conditions that presumably constrain the transferee and may provide more than a trivial benefit to the transferor including the following:

- A provision that prohibits selling or pledging a transferred loan receivable. This condition not only constrains the transferee but also provides the transferor with the more-than-trivial benefit of knowing who holds the financial asset (a prerequisite to repurchasing the financial asset) and of being able to block the financial asset from being transferred to a competitor for the loan customer's business (ASC 860-10-40-17(a)).

- Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed to with the transferor (ASC 860-10-40-17(b)).

Prohibitions or limitations, whether imposed by the transferor or otherwise known by the transferor, are problematic because they limit the transferee's ability to realize the economic benefits of the transferred financial asset.

An example of such a limitation may include a prohibition from selling a transferred financial asset to the transferor’s competitor when that competitor is the only other potential buyer in the marketplace. In these circumstances, the transferee is constrained from obtaining the benefits of the transferred financial asset, and the transferor likely retains a more than trivial benefit. The benefit to the transferor may include knowing who holds the transferred financial asset and preventing that asset from benefiting a competitor.
Some rights or obligations to reacquire transferred financial assets or beneficial interests, including all of the following:

- A freestanding call option written by a transferee to the transferor may benefit the transferor and, if the transferred financial assets are not readily obtainable in the marketplace, is likely to constrain a transferee because the transferee might have to default if the call option was exercised and the transferee had pledged or exchanged the financial assets (ASC 860-10-40-17(c)(1)).

- A freestanding forward purchase-sale contract between the transferor and the transferee on transferred financial assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee (ASC 860-10-40-17(c)(3)).

- A call option to repurchase third-party beneficial interests at the price paid plus a stated return if the third-party holders of its beneficial interests are constrained from pledging or exchanging their beneficial interests due to that call option (ASC 860-10-40-17(c)(1A)).

- A call option written by a transferee to the transferor that is sufficiently deep-in-the-money, if the transferred financial assets are not readily obtainable in the marketplace, because the transferee would be more likely to have to hold the assets to comply with a potential exercise of the call option (ASC 860-10-40-17(c)(2)).

- A deep-in-the-money written put option on a transferred financial asset effectively constrains the transferee and therefore may preclude sale accounting. A constraint exists because the option’s exercise price effectively ensures the transferee would forgo its right to pledge or exchange the transferred financial asset to a third party. If it were to seek to reclaim the financial asset, the transferor receives a premium for writing the put option. In this circumstance, the transferor may benefit from knowing the location of the financial asset and preventing its competitors’ access to such financial asset. Deep-in-the-money put options may also preclude sale accounting under ASC 860-10-40-5(c) because it is probable the transferor will obtain the transferred financial asset (refer to Chapter 5, Criteria for a sale — Effective control).

4.4 Examples of conditions that presumptively do not constrain the transferee

Some conditions, in of themselves, do not necessarily constrain a transferee from pledging or exchanging a financial asset, including the following:

- A transferor’s right of first refusal on a bona fide offer from a third party.

  A transferor’s right of first refusal on the occurrence of a bona fide offer to the transferee from a third party, because that right in itself does not enable the transferor to compel the transferee to sell the financial asset and the transferee would be in a position to receive the sum offered by exchanging the financial asset, albeit possibly from the transferor rather than the third party (ASC 860-10-40-18(a)).

- A requirement to obtain the transferor’s permission to sell or pledge that is not to be unreasonably withheld (ASC 860-10-40-18(b)).

Determining when a requirement to obtain a transferor’s approval constrains a transferee from taking advantage of its right to pledge or to exchange the transferred financial asset requires consideration of the nature of the requirement for approval (see ASC 860-10-55-31). A requirement to obtain the transferor’s permission to pledge or exchange that cannot be unreasonably withheld by the transferor is generally not considered a substantive constraint. Conversely, if determining whether to grant permission is at the transferor’s sole discretion, this condition would effectively constrain the transferee. In the latter instances, the transferor incurs a cost, because the transferee
would presumably pay less than it would to obtain the financial asset without the constraint. Additionally, that constraint presumptively provides the transferor with a more-than-trivial benefit because the transferor would only incur such costs if there was a resulting benefit.

- A prohibition on sale to the transferor’s competitor if other potential willing buyers exist (ASC 860-10-40-18(c)).

A prohibition on sale to the transferor’s competitor may or may not constrain a transferee from pledging or exchanging the financial asset, depending on how many other potential buyers exist. If there are many other potential willing buyers, the prohibition would not be constraining. In contrast, if that competitor were the only potential willing buyer (other than the transferor), then the condition would be constraining (ASC 860-10-55-32).

- A regulatory limitation such as on the number or nature of eligible transferees (as in the circumstance of securities issued under Securities Act Rule 144A or debt placed privately) (ASC 860-10-40-18(d)).

Some constraints, not imposed directly by a transferor, originate within certain regulatory environments and do not necessarily represent constraints that provide the transferor a more-than-trivial benefit. For example, issuing beneficial interests in the form of securities issued under Rule 144A presumptively would not constrain a transferee’s ability to transfer those beneficial interests for purposes of ASC 860-10-40-5(b). The primary limitation imposed by Rule 144A is that a potential buyer must be a sophisticated investor. If a large number of qualified buyers exist, the holder could transfer those securities to many potential buyers and, thereby, realize the full economic benefit of the assets. In such circumstances, the requirements of Rule 144A would not be a constraint that precludes sale accounting.

- Illiquidity, for example, the absence of an active market (ASC 860-10-40-18(e)).

Illiquidity, in and of itself, generally does not preclude sale accounting because the transferee is still able to freely pledge or exchange the transferred financial asset if and when the opportunity presents itself.

- Freestanding rights to reacquire transferred assets that are readily obtainable (ASC 860-10-40-18(g)).

This circumstance differs from the freestanding call option on a non-readily obtainable financial asset discussed in section 4.3 above. In this circumstance, if the transferor were to exercise its rights under the call option, the transferee could always reacquire a similar financial asset from the market place and therefore avoid the risk of defaulting on its obligation. An attached call option\(^\text{18}\) generally would not constrain the transferee from pledging or exchanging any transferred financial asset (whether that financial asset is readily obtainable or not). An attached call, by definition, follows the financial asset subject to the call such that if the transferee sold the transferred financial asset with an attached call, the obligation to satisfy the call would reside with the subsequent purchaser of the transferred financial asset and not with the transferee. Therefore, upon pledging or exchanging the financial asset, the transferee is no longer the counterparty to the call and therefore not exposed to the risk of default.

\(^{18}\) An attached call option is an option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call is traded with and diminishes the value of the underlying instrument transferred subject to that call option.
An embedded call option\(^{19}\) does not constrain the transferee and does not maintain the transferor’s effective control over the transferred financial asset because that call option is held by the issuer of the financial asset and not the transferor.

Deep-out-of-the-money written put options on a transferred non-readily obtainable financial asset are generally not considered to be substantive constraints. In this circumstance, because the option is deep out of the money, it is probable at inception that the option will not be exercised. Therefore the transferee is free to pledge and exchange the transferred financial asset without a substantive risk of default as discussed above.

The provisions listed above should be considered in connection with the other provisions and restrictions included in the rights retained by the transferor and its consolidated entities and its agents. A single provision may not constrain the transferee individually, but it may do so when considered in combination with other agreements and arrangements.

Questions and interpretive responses

**Question 4-1** Transferee is constrained, but the transferor has no continuing involvement

Assume an entity transfers financial assets to an entity that is neither a securitization entity nor an entity whose sole purpose is to facilitate an asset-backed financing. The transferee is significantly limited in its ability to pledge or exchange the transferred assets. The transferor receives cash in return for the transferred financial assets and has no explicit or implicit continuing involvement with the transferred assets. Does the transfer meet the requirements of ASC 860-10-40-5(b)?

Yes. ASC 860-10-40-16A\(^{20}\) clarifies that if a transferor receives only cash in return for the transferred financial assets and the transferor, its consolidated affiliates included in the financial statements being presented and its agents have no continuing involvement with the transferred financial assets, sale accounting is allowed under ASC 860-10-40-5(b) even if the transferee entity is significantly limited in its ability to pledge or exchange the transferred assets. The FASB reasoned that a transferred financial asset from which the transferor can obtain no further benefits is no longer its financial asset and should be removed from its statement of financial position.

However, any further involvement with the transferred financial asset, other than standard representations and warranties, is considered continuing involvement. Therefore, the level of continuing involvement with the transferred financial asset, inclusive of the effect of any existing constraint, must be assessed to determine if that constraint provides the transferor with more than a trivial benefit. If so, the transferor has not relinquished control over the transferred financial asset, and sale accounting is precluded.

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\(^{19}\) An embedded call option is an option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

\(^{20}\) Also refer to ASC 860-10-55-28 and 55-29.
**Question 4-2**

**Forms of continuing involvement that do not preclude sale accounting**

If the transferee is constrained from pledging or exchanging the asset received, does any form of continuing involvement provide the transferor with more than a trivial benefit?

No. The nature of the continuing involvement should be evaluated. For example, continuing involvement in the form of standard representations and warranties does not provide the transferor with more than a trivial benefit. Additionally, custodial services or other limited administrative services, which do not constitute control over the transferred financial asset, would not provide the transferor with more than a trivial benefit if such services are provided at a price that is not contingent upon the performance of the underlying asset.

**Question 4-3**

**Transfers between entities under common control**

Should a transferor-subsidiary consider the involvements of its parent if it transfers a financial asset to another subsidiary of the parent?

ASC 860-10-40-4 states that in a transfer between two subsidiaries of a common parent, the transferor-subsidiary shall not consider its parent’s involvement with the transferred financial assets in applying the derecognition conditions specified in ASC 860-10-40-5.

**Question 4-4**

**Transferee’s ability to pledge or exchange**

To not be constrained, must a transferee be able to both pledge and exchange the transferred financial asset?

ASC 860-10-55-27 clarifies that the answer depends on the facts and circumstances. The key aspect of the analysis is the determination of whether the transferee is able to obtain all or most of the economic benefit from the transferred financial asset (i.e., the ability to obtain all or most of the cash inflows, either by exchanging the transferred financial asset or by pledging it as collateral).

**Question 4-5**

**Transferee’s limited ability to pledge or exchange**

Does the transferee’s ability to pledge or exchange only credit impaired financial assets satisfy the derecognition requirements specified in ASC 860-10-40-5(b)? Assume the transferee is not an entity whose sole purpose is designed to facilitate securitization or asset-backed financing activities.

No. As indicated in ASC 860-10-40-16A and ASC 860-10-55-28, when the transferee has only a limited ability to pledge or exchange the transferred financial asset, the transferee would not be able to sell or pledge in a way that allows it to realize all (or most) of the cash flows from the transferred financial asset. Being able to freely pledge or exchange its financial asset, such as to realize appreciation in value, is a substantial right that must be conveyed to a transferee for control to have been relinquished.

**Question 4-6**

**Considering the role of the portfolio manager when assessing constraints**

Could the transferor’s role as portfolio manager of transferred financial assets be considered a constraint?

Based on the facts and circumstances, a transferor’s role as a portfolio manager may effectively constrain the transferee. For example, in a transaction that does not involve a securitization entity, the transferee may have the contractual right to pledge or exchange the assets, but be constrained from doing so because of the transferor’s ability as portfolio manager to control all asset disposition decisions. ASC 860-10-40-17 indicates that the ability to pledge or exchange financial assets only on terms agreed to by the transferor is considered a constraint and could provide more than a trivial benefit to the transferor. One factor to consider is whether the transferee has substantive “kick-out rights.” If the transferee has the ability to replace the portfolio manager, the manager’s control over investment decisions may not be considered a transferee constraint.
In situations in which the transferee is an asset-backed or securitization entity, the evaluation would instead consider the beneficial interest holders’ rights to pledge or exchange their beneficial interests. Because such restrictions are not typical, the fact that the transferor is also the portfolio manager may not preclude sale accounting.
5 Criteria for a sale – Effective control

5.1 Introduction

This chapter focuses on the criterion outlined in ASC 860-10-40-5(c), which requires that for sale accounting to be achieved, the transferor cannot maintain effective control over the transferred financial assets.

5.2 Effective control criterion

Excerpt from Accounting Standards Codification

Conditions for a Sale of Financial Assets

860-10-40-5

A transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

a. [EY note: Condition omitted; see Chapter 3, Criteria for a sale – Legal isolation]

b. [EY note: Condition omitted; see Chapter 4, Criteria for a sale – Right to pledge or exchange]

c. Effective control. The transferor, its consolidated affiliates included in the financial statements being presented, or its agents do not maintain effective control over the transferred financial assets or third-party beneficial interests related to those transferred assets (see paragraph 860-10-40-22A). A transferor’s effective control over the transferred financial assets includes, but is not limited to, any of the following:

1. An agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 860-10-40-23 through 40-27)

2. An agreement, other than through a cleanup call (see paragraphs 860-10-40-28 through 40-39), that provides the transferor with both of the following:
   i. The unilateral ability to cause the holder to return specific financial assets
   ii. A more-than-trivial-benefit attributable to that ability.

3. An agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them (see paragraph 860-10-55-42D).

The guidance in ASC 860-10-40-5(c) focuses on determining whether a transferor has relinquished effective control over transferred financial assets when certain arrangements exist that require or permit the transferor to reacquire such financial assets. When the transferee is a securitization entity that issues beneficial interests in the transferred financial assets, the evaluation of whether the transferor maintains effective control over the transferred financial assets should consider its control over the third-party beneficial interests. This concept is discussed further in section 5.4.1.1.
For the remainder of this chapter, when the terms “financial asset” and “transferee” are used, the same principles and guidance would apply to “beneficial interests” and “third-party holders of those beneficial interests” issued by an entity whose sole purpose is to facilitate securitizations or asset-backed financing activities whether or not specifically stated.

### 5.2.1 Use of judgment

Judgment is required to assess whether the transferor maintains effective control over transferred financial assets. As part of the assessment, the transferor should consider all arrangements made contemporaneously with, or in contemplation of, the transfer, even when such arrangements are not entered into concurrently with the transfer. The transferor should consider its continuing involvement as well as that of its consolidated affiliates included in the financial statements being presented and its agents in evaluating the derecognition criteria of ASC 860-10-40-5.

When assessing effective control, ASC 860-10-40-22A explains that the transferor considers the involvement of an agent only when the agent acts for and on behalf of the transferor. If the transferor and transferee have the same agent, the agent’s activities on behalf of the transferee should not be considered in the transferor’s evaluation of whether it has effective control over a transferred financial asset. For example, an investment manager may act as a fiduciary (agent) for both the transferor and the transferee; therefore, the transferor need only consider the involvement of the investment manager if it is acting on its behalf. Refer to question 5-4.

### 5.3 Agreements that both entitle and obligate the transferor to repurchase or redeem transferred financial assets

Under ASC 860-10-40-5(c)(1), the transferor is presumptively considered to maintain effective control over the transferred financial asset if there is an agreement that both entities and obligates the transferor to repurchase it before its maturity. Repurchase agreements (repos) and securities lending transactions are examples of typical arrangements containing such provisions.

Arrangements in which the transferor has only a right (i.e., an option, which may not be exercised) to repurchase the transferred financial asset do not provide the transferor with effective control of the transferred financial asset under ASC 860-10-40-5(c)(1). Similarly, an arrangement in which the transferor is allowed to net settle the transaction, rather than physically deliver the asset, also does not meet the ASC 860-10-40-5(c)(1) condition for the transferor to maintain effective control. However, certain of these transferor rights may preclude sale accounting under ASC 860-10-40-5(c)(2).

Not all arrangements that both entitle and obligate a transferor to repurchase the transferred financial assets result in the transferor maintaining effective control over the assets. For example, the transferor has not maintained effective control if:

- The arrangement does not require the repurchase of the same or “substantially the same” asset(s) as described in ASC 860-10-40-24 and ASC 860-10-55-35
- The arrangement does not require the transferor to repurchase the transferred financial assets before maturity at a fixed or determinable price
- The arrangement to reacquire the transferred financial assets is not entered into contemporaneously with, or in contemplation of, the transfer

In these instances, assuming the other derecognition conditions of ASC 860-10-40-5(a) and 40-5(b) are met, the transfer would be accounted for as sale with a forward repurchase commitment.
Securities lending transactions, repurchase agreements, dollar-rolls and repurchase financings, including the application of the effective control criteria to these arrangements, are discussed further in Chapter 9, *Securities lending, repurchase agreements and repurchase financing arrangements*.

5.4 Transferor's unilateral ability to cause the return of specific transferred financial assets

The second type of effective control described in ASC 860-10-40-5(c) applies to a broader group of agreements whose terms provide the transferor (or any of its consolidated affiliates included in the financial statements being presented) both:

- The ability to unilaterally reclaim specific transferred financial assets
- A more-than-trivial benefit attributable to that ability

Examples of arrangements that could provide the transferor effective control include call options, including removal-of-accounts provisions, an ability to dissolve a securitization entity and regain control of the underlying financial assets and a freestanding forward purchase-sale contract between the transferor and transferee. ASC 860 also clarifies that all arrangements or agreements made contemporaneously with, or in contemplation of, the financial asset transfer should be considered to determine the accounting.

See question 5-1 for additional interpretive guidance.

5.4.1 Call options and determination of more than a trivial benefit

**Excerpt from Accounting Standards Codification**

860-10-40-28(a)

A call option or other right conveys more than a trivial benefit (that is, fails the condition in paragraph 860-10-40-5(c)(2)(ii)) if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it.

As used in ASC 860-10-40-28(a), we believe the phrase “potentially advantageous” should be interpreted as any ability to repurchase transferred financial assets at a price that is less than the financial assets’ fair value at the time of repurchase. For example, a call option held by the transferor that has a fixed exercise price based on the fair value of the financial assets on the day of the transfer is potentially advantageous because the market price for the underlying assets could increase after the initial transfer date. All facts and circumstances should be considered in determining whether this criterion has been met. Terms in transaction documents that are meant to approximate fair value should not necessarily be considered fair value for purposes of this evaluation.

5.4.1.1 Call options that preclude sale accounting

**Fixed price call options**

For the reasons noted in section 5.4.1, a call option on a specific transferred financial asset at a price fixed at its principal amount maintains the transferor’s effective control over the associated financial asset.

**Freestanding fair value call options on non-readily obtainable assets**

A freestanding call option that allows the transferor to reclaim transferred financial assets by paying their fair value when reclaimed may preclude sale accounting if the financial assets are not readily obtainable in the marketplace. The call option gives the transferor the unilateral ability to repurchase the
assets and because the assets are not readily obtainable, that ability may provide the transferor with a more-than-trivial benefit (e.g., by knowing where the assets can be reclaimed or by preventing the transferee from further transferring the assets to a competitor).

Effective control over transferred financial assets can be present even if the right to reclaim is indirect. The following implementation guidance from ASC 860-10-40-28(b) and 40-28A illustrate this point:

- If a call allows a transferor to buy back the beneficial interests at a fixed price, the transferor may maintain effective control of the financial assets underlying those beneficial interests. If the transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities, that entity may be constrained from choosing to pledge or exchange the transferred financial assets. In that circumstance, any call held by the transferor on third-party beneficial interests is effectively an attached call on the transferred financial assets. Depending on the price and other terms of the call, the transferor may maintain effective control over the transferred financial assets.

- A transferor’s unilateral ability to cause a securitization entity to return to the transferor or otherwise dispose of specific transferred financial assets, for example, in response to its decision to exit a market or a particular activity, has the characteristic in ASC 860-10-40-5(c)(2)(i) and, thus, would provide the transferor with effective control over the transferred financial assets if it also provides more than a trivial benefit to the transferor.

### 5.4.1.2 Call options that do not preclude sale accounting

ASC 860-10-40 provides examples of call options that do not preclude sale accounting:

- Cash-settled call options do not constrain the transferee, nor do they result in the transferor maintaining effective control because they do not provide the transferor with an opportunity to reclaim the transferred financial assets (ASC 860-10-40-31).

- An embedded call option would not result in the transferor’s maintaining effective control because it is the issuer rather than the transferor who holds the call option and the call option does not provide more than a trivial benefit to the transferor. For example, a call embedded by the issuer of a callable bond or the borrower of a prepayable mortgage loan would not provide the transferor with effective control over the transferred financial asset (ASC 860-10-40-32).

- A right to reclaim specific transferred financial assets by paying their fair value when reclaimed generally does not maintain effective control if it does not convey a more-than-trivial benefit to the transferor (ASC 860-10-40-35). For example, ASC 860-10-40-28(c) states that a call option on readily obtainable assets at fair value may not provide the transferor with more than a trivial benefit. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred financial assets. See section 5.4.4 for additional guidance.

- An out-of-the-money fixed price call option that entitles the transferor to buy back the transferred financial assets or related beneficial interests would not maintain the transferor’s effective control over the transferred financial asset if that price is so far out of the money or for other reasons it is probable when the call option is written that the transferor will not exercise it. ASC 860-10-40-28(a) clarifies that the probability of an option being exercised and its potential effect on the accounting for a related transfer of financial assets is assessed only at the time the option is written.
The following are other examples of the application of the effective control principles:

**Excerpt from Accounting Standards Codification**

**860-10-55-42**

a. In a loan participation, the lead bank (that is also the transferor) allows the participating bank to resell but reserves the right to call at any time from whoever holds it and can enforce the call option by cutting off the flow of interest at the call date; such a call option precludes sale accounting.

b. In a securitization, a call option permits the transferor to reclaim all of the transferred financial assets from the securitization entity at any time; such a call option precludes sale accounting unless both of the following conditions exist:

   1. The call option is an option to call, at fair value, a financial asset that is readily obtainable in the marketplace.

   2. The transferor does not hold a residual beneficial interest in the transferred financial assets (see paragraph 860-10-40-35).

c. A transferor-servicer transfers a group of entire financial assets to a securitization entity and has the right to call all of the financial assets when the group amortizes to 20 percent of its value (determined at the date of transfer). The transferor-servicer determines that at that level of financial assets, its cost of servicing them would not be burdensome in relation to the benefits of servicing, and therefore that the call option is not a cleanup call. Such a call option precludes sale accounting for the entire group of transferred financial assets (see paragraph 860-10-55-70).

d. If the third-party beneficial interests contain an embedded option and the transferor holds the residual interest in the securitization entity, the combination has the same kind of effective control as a scheduled auction provision if the transferor holds a residual beneficial interest. Sale accounting would be precluded for all of the transferred financial assets affected by the call option.\[21\]

e. If the third-party beneficial interests in a securitization entity pay off first (a so-called turbo structure, where principal payments and prepayments are allocated on a non-pro rata basis, as discussed in paragraph 860-10-05-13), the transferor may not maintain effective control over transferred financial assets (see paragraph 860-10-40-32). To some extent, these repayments are contractual cash flows of the underlying assets, but repayments also result from prepayments in the underlying assets (that is, the prepayment options in the underlying assets are mirrored in the third-party beneficial interests). In this circumstance, call options embedded in the third-party beneficial interests result from the options embedded in the underlying assets (that is, they are held by the underlying borrowers rather than the transferor), and thus do not preclude sale accounting.

f. A transferor’s contractual right to repurchase, at any time, a loan that is not a readily obtainable financial asset would preclude sale accounting, because the transferor’s contractual right to repurchase is effectively a call option of the type described in paragraph 860-10-40-17(c)(2).

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\[21\] EY note: See question 5-6 for additional implementation guidance on a transferor retaining a residual interest in the transferred financial assets.
5.4.2 Removal-of-accounts provision (ROAP)

ASC 860-10-40-36 explains that many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions. Such a power is commonly referred to as a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor maintaining effective control over transferred financial assets. If it is determined that a ROAP allows the transferor to unilaterally cause the return of specific assets, that provision must also be analyzed to determine whether it provides the transferor with more than a trivial benefit.

5.4.2.1 Examples of ROAPs that preclude sale accounting

The following examples of ROAPs typically cause a transfer of financial assets to be accounted for as a secured borrowing:

- **Unconditional** – An unconditional removal-of-accounts provision that allows the transferor to specify the financial assets that may be removed from a group of financial assets precludes sale accounting for all financial assets in the group that might be specified if such a provision allows the transferor unilaterally to remove specific financial assets and provides a more-than-trivial benefit to the transferor (see ASC 860-10-40-37(a)), even if the transferor’s right to remove specific financial assets from a group of transferred financial assets is limited, for example, to 10 percent of the fair value of the financial assets transferred and all of the financial assets are smaller than that 10 percent. In that circumstance, none of the transferred financial assets would be derecognized at the time of transfer because no transferred financial asset is beyond the reach of the transferor. If the transferor reclaims all the financial assets it can, and thereby extinguishes its option, its control has expired and the rest of the financial assets will be considered sold at that time.\(^{22}\)

- **Transferor’s decision to exit portion of a business** – A removal-of-accounts provision conditioned on a transferor’s decision to exit some portion of its business that provides a more-than-trivial benefit to the transferor precludes sale accounting, because whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party’s bid to purchase a specified (e.g., geographic) portion of the transferor’s business, such a provision allows the transferor unilaterally to remove specific financial assets.\(^{23}\)

Both of the examples above would preclude sale accounting only when the right provides the transferor with a more-than-trivial benefit. The more-than-trivial benefit may be derived from the ROAP’s exercise price (e.g., if the exercise price of the ROAP is below fair value) or from providing the transferor the ability to keep access to its customers in the event of its own decision to exit a business. All facts and circumstances should be considered when determining whether the right to reacquire assets provides the transferor with a more-than-trivial benefit.

\(^{22}\) Example adopted from ASC 860-10-55-41(a).

\(^{23}\) Example adopted from ASC 860-10-40-37(b) and ASC 860-10-55-41(c).
Examples of ROAPs that do not preclude sale accounting

The following examples of ROAPs typically do not preclude a transfer of financial assets from being accounted for as a sale:

- **Random removal of excess assets** – A removal-of-accounts provision for random removal of excess financial assets, if the provision is sufficiently limited so that the transferor cannot remove specific transferred financial assets (e.g., by limiting removals to the amount of the transferor’s interests and to one removal per month (ASC 860-10-40-38(a))).

  A ROAP that permits the transferor to randomly select and reclaim excess assets (e.g., when the transferee’s existing assets will more than adequately provide for cash flows necessary to meet its obligations) does not in and of itself preclude sale accounting if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred financial assets.

  Consider the following implementation guidance from ASC 860-10-55-41(b):

  A removal-of-accounts provision that provides the right to random removal of excess financial assets from a group of transferred financial assets up to 10 percent of the fair value of the financial assets transferred (all financial assets in the group are less than this 10 percent of the fair value of transferred financial assets) does not preclude sale accounting if the transferor has no other interest in the group. The transferor has, in essence, obtained a 10 percent beneficial interest in the group and should account for it as such. This treatment is permitted because the removal-of-accounts provision is sufficiently limited and the transferor cannot unilaterally remove specific transferred financial assets, because the timing of the removal (when the excess develops) and the assets being removed (which are randomly determined) are not under the control of the transferor.

- **Contingent ROAPs and calls** – A removal-of-accounts provision or call that can be exercised only in response to a third party’s action (e.g., a contingent ROAP) that has not yet occurred does not maintain the transferor’s effective control over financial assets as the transferor would not be able to unilaterally cause the return of assets subject to that ROAP. However, when a third party’s action (e.g., borrower default) or inaction (e.g., option expires) occurs that allows removal of financial assets to be initiated solely by the transferor and that right provides a more-than-trivial benefit to the transferor, the transferor must recognize any financial assets subject to the ROAP, whether or not the ROAP is exercised.

  If the ROAP is exercised, the financial assets are recognized because the transferor has repurchased the financial assets. However, even if the ROAP is not exercised, the financial assets subject to the ROAP are recognized once the ROAP becomes exercisable because the transferor now has the unilateral ability to cause the transferee to return those specific financial assets, and therefore the transferor once again has effective control over those transferred financial assets. See section 6.6 for further discussion of the accounting requirements when a transferor regains control of a previously sold financial asset.

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24 See also ASC 860-10-40-38(d) and 40-39.
Criteria for a sale — Effective control

- Removal of defaulted assets and removal conditioned on third-party decision

**Excerpt from Accounting Standards Codification**

**860-10-55**

55-41(d) A removal-of-accounts provision for defaulted receivables does not preclude sale accounting at the time of transfer, because the removal would be allowed only after a third party's action (default) and could not be caused unilaterally by the transferor (see paragraph 860-10-40-38(b)). However, once the default has occurred, the transferor would have the unilateral ability to remove those specific financial assets and would need to recognize the defaulted receivable if that ability provides a more-than-trivial benefit to the transferor.

55-41(e) A removal-of-accounts provision conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement does not preclude sale accounting at the time of transfer, because the removal would be allowed only after a third party's action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor (see paragraph 860-10-40-38(c)). However, once the cancellation or expiration has occurred, the transferor would have the unilateral ability to remove specific financial assets and would need to recognize those financial assets if that ability provides a more-than-trivial benefit to the transferor.

55-41(f) Because the transferor could not cause the reacquisition unilaterally a transferor does not maintain effective control through a removal-of-accounts provision that obligates the transferor to reacquire transferred financial assets from a securitization entity only after either:

1. A specified failure of the servicer to properly service the transferred financial assets that could result in the loss of a third-party guarantee
2. Third-party beneficial interest holders require a securitization entity to repurchase that beneficial interest.

### 5.4.3 Cleanup call option

**Excerpt from Accounting Standards Codification**

**Cleanup Call Option**

An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

As an exception to the effective control criteria, cleanup call options do not require re-recognition of the transferred financial assets until the option is exercised even though that right, once exercisable, provides the transferor with both the unilateral ability to cause the holder to return the remaining financial assets and a more-than-trivial benefit attributable to that ability.

Typically, the terms of the cleanup call are determined at the time of the financial asset transfer or servicing arrangement and, by definition, the call is not exercisable until the cost of servicing becomes burdensome. If the call is exercisable prior to the point when servicing becomes burdensome, it is not a cleanup call and sale accounting is generally precluded.
ASC 860 does not specify the level at which the cost of servicing would become burdensome. In practice, many arrangements identify the point of time when servicing becomes burdensome, and thus the cleanup call becomes contractually exercisable, as the point in time when a specified percentage of the financial assets being serviced remain outstanding. While this contractual percentage may vary, practice has accepted a level of 10% or less of the originally transferred financial assets. However, because there are no “safe-harbors,” an analysis of specific facts and circumstances is required to demonstrate the level at which the costs to the servicer become burdensome and the basis for that conclusion should be documented. The provisions of when a cleanup call is exercisable can consider either the transferred financial assets or related beneficial interests because the same servicing burden arises when the remaining financial assets or beneficial interests fall to a relatively small portion of the original balance.

5.4.3.1  **Limits on ability to apply the cleanup call exception**

It is important to note that ASC 860 allows the cleanup call exception only when the cleanup call is held by the servicer (which can be the transferor or an affiliate of the servicer). ASC 860-10-40-34 states that parties other than the servicer cannot hold the option, because only the servicer is burdened when the amount of outstanding financial assets falls to a level at which the cost of servicing the financial assets becomes burdensome — the defining condition of a cleanup call — and any other party would be motivated by some other incentive in exercising a call.25

5.4.3.1.1  **Cleanup call in which servicing is sub-contracted to another party**

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<tr>
<th>Excerpt from Accounting Standards Codification</th>
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<td>860-10-55-42C</td>
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<tr>
<td>In a securitization transaction involving not-readily-obtainable financial assets, a transferor that is also the servicer may hold a cleanup call if it enters into a subservicing arrangement with a third party without precluding sale accounting. Under a subservicing arrangement, the transferor remains the servicer from the perspective of the securitization entity because the securitization entity does not have an agreement with the subservicer (that is, the transferor remains liable if the subservicer fails to perform under the subservicing arrangement). However, if the transferor sells the servicing rights to a third party (that is, the agreement for servicing is between the securitization entity and the third party after the sale of the servicing rights), then the transferor could not hold a cleanup call without precluding sale accounting.</td>
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5.4.4  **Consideration of multiple arrangements and the involvement of affiliates and agents**

ASC 860-10-40-5(c)’s effective control concept does not address all of the possible arrangements between two parties that may result in the transferor retaining effective control. Accordingly, when evaluating whether a transferor maintains effective control, it is important to consider all agreements and arrangements entered into concurrent with, or in contemplation of, the transfer.

In addition to ROAPs and call options, the transferor may hold other roles in a transaction that allow it to unilaterally take back specific financial assets at potentially advantageous terms. When assessing the ASC 860 control criteria, it is important to understand all of the roles the transferor has in the transaction, including those of its affiliates included in the consolidated financial statements and its agents. In certain transactions, the transferor could be the liquidity provider, remarketing agent, administrative agent or residual holder, among other roles. These roles individually or in combination could provide the transferor with rights that enable it to unilaterally gain control over the transferred financial assets.

25 See also ASC 860-10-55-42B.
5.4.5 Differences in the assessment of the effect of call options to the “right to pledge or exchange” and “effective control” criteria for derecognition

The existence of an option may preclude sale accounting under the right to pledge or exchange criteria of ASC 860-10-40-5(b) or the effective control criteria of ASC 860-10-40-5(c), or possibly both. Consequently, each criterion should be evaluated because while the criteria are similar in some respects, each has a fundamentally different objective.

The discussion of the effect of options with regard to the ASC 860-10-40-5(c)(2) criterion relates to whether an option provides the transferor with the unilateral ability to cause the holder to return specific financial assets. However, the effect of options in the ASC 860-10-40-5(b) criterion relates to whether the option constrains the transferee from pledging or exchanging the transferred financial assets.

See question 5-4 for additional interpretive guidance.

Excerpt from Accounting Standards Codification

860-10-55-42A

This guidance illustrates the concept in paragraph 860-10-40-35 that a transferor maintains effective control if it has a right to reclaim specific transferred assets by paying fair value and also holds the residual interest in the transferred financial assets. If a transferor holds the residual interest in securitized financial assets and can reclaim the transferred financial assets at termination of the securitization entity by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the transfer of those financial assets it can reclaim would be precluded. Such circumstances provide the transferor with a more-than-trivial benefit and effective control over the financial assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest in the transferred financial assets.}\(^{26}\)

\(^{26}\) EY note: See also section 5.4.1.1.
To illustrate the difference, consider a call option that:

- Is a freestanding option held by the transferor on non-readily obtainable assets
- Is contingent and exercisable only upon the transferee reaching an agreement to sell the transferred financial assets (i.e., a right of first refusal)
- Permits the transferor to reacquire the assets at the price paid plus a stated return
- Conveys more than a trivial benefit to the transferor

When evaluating the derecognition requirements of ASC 860-10-40-5(c)(2), the call option does not, at inception, preclude sale accounting because the transferor does not maintain the unilateral ability to cause return of the transferred financial assets. That is, the right of first refusal in and of itself does not provide the transferor a unilateral ability to reclaim the transferred assets.

However, when evaluating the derecognition requirements of ASC 860-10-40-5(b), sale accounting would be precluded because the transferee is effectively constrained from pledging or exchanging the transferred financial assets as they are not readily obtainable in the market. That is, the transferee, due to its inability to locate similar assets sufficient to satisfy the call option, would be constrained from pledging or exchanging the transferred financial assets to avoid the risk of default. See Chapter 4, *Criteria for a sale — Right to pledge or exchange*, for a discussion of constraints on the transferee.

See questions 5-5, 5-6 and 5-7 for additional interpretive guidance.

### 5.5 Transferee’s ability to require the transferor to repurchase the transferred financial assets

The third example provided in ASC 860-10-40-5(c) describes an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial assets. This type of condition also allows a transferor to maintain effective control over the transferred financial assets.

ASC 860-10-55-42D provides implementation guidance that addresses the application of the derecognition requirements described in ASC 860-10-40-5(c)(3).

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
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<tbody>
<tr>
<td><strong>860-10-55-42D</strong></td>
</tr>
<tr>
<td>This implementation guidance addresses the application of paragraph 860-10-40-5(c)(3) through the following examples:</td>
</tr>
<tr>
<td>a. A put option written to the transferee generally does not provide the transferor with effective control over the transferred financial asset under paragraph 860-10-40-5(c)(3).</td>
</tr>
<tr>
<td>b. A put option that is sufficiently deep in the money when it is written would, under that paragraph, provide the transferor effective control over the transferred financial asset because it is probable that the transferee will exercise the option and the transferor will be required to repurchase the transferred financial asset.</td>
</tr>
<tr>
<td>c. A sufficiently out-of-the-money put option held by the transferee would not provide the transferor with effective control over the transferred financial asset if it is probable when the option is written that the option will not be exercised.</td>
</tr>
<tr>
<td>d. A put option held by the transferee at fair value would not provide the transferor with effective control over the transferred financial asset.</td>
</tr>
</tbody>
</table>
Questions and interpretive responses

Question 5-1  Unilateral ability to reclaim specific assets

Assume the transferor transfers debt securities that have an average maturity of five years to a trust. The trust issues 30-day commercial paper beneficial interests in the debt securities and the transferor retains the residual interest. The 30-day beneficial interests continually roll over throughout the life of the trust. The transferor is not precluded from bidding in the beneficial interests’ remarketing process. If the transferor has the right to repurchase any transferred asset it chooses at a fixed price, but the right is limited to 20% of the transferred financial assets, does the transaction qualify for sale accounting?

No. Because the transferor still has the ability to repurchase any of the transferred financial assets up to a defined limit at a fixed price, sale accounting is precluded for all of the financial assets transferred until sufficient repurchases occur to reach the limit. In this circumstance, the fixed price arrangement provides the transferor with potentially advantageous pricing and, therefore, a more-than-trivial benefit associated with its right to unilaterally reclaim transferred financial assets. However, once the transferor has repurchased up to the 20% limit, the remaining financial assets transferred would be treated as a sale, assuming all other derecognition criteria are met. Additionally, if any single asset exceeds the limit such that it could not be repurchased, that asset would be considered sold for accounting purposes if the other derecognition criteria are met.

Question 5-2  Transferor retains a residual interest in the transferred financial assets

Assume the transferor transfers municipal bonds with an average life of 15 years to a trust. The trust issues two-year senior beneficial interests in the municipal bonds to investors with the transferor continuing to hold the residual interest. The trust terminates upon the maturity of the beneficial interests, and the transferor is not precluded from participating in an auction to purchase the underlying municipal bonds at the termination of the trust. Has the transferor met the criterion of ASC 860-10-40-5(c)(2) to have relinquished effective control?

No. The ability to unilaterally control the transferred assets is present if the transferor has the ability to participate in an auction and holds the residual interest. If the transferor holds the residual, it has the ability to control the bid process because any difference between its bid and market would be recovered through the residual interest it holds. See also ASC 860-10-55-42A. Accordingly, the requirements of ASC 860-10-40-5(c)(2) would not be met, and the transfer would be accounted for as a secured borrowing.

Question 5-3  Options on specified transferred financial assets

If the transferor has the unilateral right (call option) to repurchase a participating interest (as defined in ASC 860-10-40-6A) in an entire transferred financial asset at a fixed price, is sale accounting precluded for the other participating interests transferred?

No. If the transferor holds such a right, sale accounting is precluded only for the specific participating interests subject to that right. In this instance, assuming all other derecognition criteria specified in ASC 860-10-40-5 are met and all of the interests meet the definition of a participating interest, the transferor would recognize a sale for the transferred participating interests not subject to such a right and account for the transfer of the participating interest subject to the call option as a secured borrowing.
Question 5-4  
**Transferor's consideration of an agent's involvements with transferred financial assets**

Does the mere presence of a common investment manager cause a transfer between affiliated investment companies to fail sale accounting?

No. The mere presence of a common investment manager does not cause the transferor to fail sale accounting, even though the investment manager could decide to resell the security to the original transferor.

For example, assume Investment Company X transfers a security to Investment Company Y in exchange for cash and an equity interest in Investment Company Y. Manager Z is the investment manager for both investment companies and as such, has full decision-making power over the assets under management. Investment Company X does not consolidate Investment Company Y and there is no written arrangement that explicitly entitles Investment Company X to reacquire the transferred assets (e.g., through a call option). Additionally, the purchase agreement contains no provision that prevents Investment Company Y from selling or pledging the security it received.

To assess whether the transferor maintains effective control over the transferred financial assets, ASC 860 clarifies that all continuing involvement by the transferor, its consolidated affiliates included in the financial statements being presented or its agents should be considered continuing involvement by the transferor. However, ASC 860-10-40-22A clarifies that when assessing effective control, the transferor should consider the involvement of an agent only when such agent is acting on its behalf. Accordingly, if the same investment manager acts as a fiduciary (agent) for both the transferor and transferee, only the involvement of the investment manager when acting on behalf of the transferor should be considered.

The investment manager has a fiduciary responsibility to perform the required duties in the best interests of the investors in the managed entities. In other words, when the investment manager executes a transfer of securities between funds under common management, the investment manager is a dual agent, and its decisions are intended to be fair and equitable for both the transferor fund and the transferee fund. Therefore, absent an explicit arrangement that entitles the transferor fund to reacquire the transferred assets, the mere presence of a common investment manager with full investment discretion as described above does not cause the transferor to fail the requirements for sale accounting.

Question 5-5  
**Transferor's indirect ability to reclaim transferred financial assets**

If a transferor has the ability to dissolve a securitization entity (e.g., through the beneficial interests that it holds) and reassume control of the transferred financial assets at any time, is the transferor precluded from accounting for the transfer as a sale?

Yes. ASC 860-10-55-67(b) states that the transferor's current ability to dissolve the securitization entity and reassume control of the transferred financial assets entitles it to unilaterally cause the return of the transferred financial assets, indicating that the transferor has maintained control over the transferred financial assets which precludes sale accounting under ASC 860-10-40-5(c).
Question 5-6

Transferor's ability to reclaim transferred financial assets only after the assets have paid-down to a predefined level

In certain transactions, the transferor is entitled to repurchase a transferred amortizing, individual (specific) financial asset when its remaining principal balance reaches some specified amount, for example, 30 percent of the original balance. To exercise that call option, the transferor would pay the remaining principal balance. Under ASC 860, is such a transfer to be accounted for partially as a sale and partially as a secured borrowing?

A call that gives the transferor the ability to unilaterally cause whoever holds the transferred financial assets to return the remaining portion of an entire financial asset to the transferor and provides more than a trivial benefit to the transferor precludes sale accounting for the entire financial asset. ASC 860 requires that derecognition provisions be applied to a transfer of an entire financial asset, a group of entire financial assets or a participating interest in an entire financial asset. ASC 860-10-55-68A prohibits accounting for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing.\(^{27}\)

ASC 860 provides the following additional implementation guidance:

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
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<tr>
<td><strong>860-10-55-70</strong></td>
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<tr>
<td>If a transferor holds a call option to repurchase at any time a few specified, individual loans from an entire group of loans transferred in a securitization transaction, then sale accounting is precluded only for the specified loans subject to the call option, not the whole group of loans. In contrast, if the transferor holds a call option to repurchase from the group any loans it chooses, up to some specified limit, then sale accounting is precluded for the transfer of the entire group while that option remains outstanding. See paragraphs 860-10-55-39 through 55-42 for related guidance.</td>
</tr>
</tbody>
</table>

Question 5-7

Transfer of bad debt recovery rights

A financial institution (transferor) transfers to a third-party transferee the right to an amount of future recoveries from loans previously written off by the transferor as uncollectible. The transferee is entitled to recoveries equal to the purchase price plus a market rate of interest on the unrecovered purchase price. There is no recourse to the transferor. The transferee can initiate its own collection efforts if dissatisfied with the transferor's recovery efforts. Is such a transfer eligible for sale accounting, or does it represent a secured borrowing?

ASC 860-10-55-73 states that the transaction is a secured borrowing (that is, a borrowing secured by the transferred rights). We believe this transaction does not meet the requirements for sale accounting because the transferred interest does not represent an entire financial asset or a participating interest in an entire financial asset (i.e., a unit of account eligible for derecognition as explained in ASC 860-10-40-4A).

\(^{27}\) The guidance in the response to question 5-6 is based on question 50 of the FASB Staff's Special Report, *Questions and Answers Related to Implementation of FASB Statement No. 140*, as amended by Statement 166 and ASC 860-10-55-68 and 55-68A.
6 Recognition and measurement

6.1 Introduction
This chapter primarily discusses the accounting for transfers that qualify as a sale, including the initial and subsequent measurement of assets obtained and liabilities incurred, and the calculation of any related gain or loss.

6.2 Basic principles
The following paragraph from ASC 860 discusses the accounting for transfers of an entire financial asset or group of entire financial assets that qualify as sales:

Excerpt from Accounting Standards Codification
Sale of an Entire Financial Asset or Group of Entire Financial Assets
860-20-40-1B
Upon completion of a transfer of an entire financial asset or a group of entire financial assets that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

a. Derecognize the transferred financial assets
b. Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale

c. Recognize in earnings any gain or loss on the sale

If the transferred financial asset was accounted for under Topic 320 as available for sale before the transfer, item (a) requires that the amount in other comprehensive income be recognized in earnings at the date of transfer.

While the basic derecognition principles are similar, additional guidance for the derecognition of participating interests is provided because the carrying amount of the entire financial asset subject to participation must be allocated between the portion sold and the portion retained.

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28 EY note: ASC 860-20-25-2 explains that although a transfer of securities may not be considered to have reached completion until the settlement date, ASC 860 does not modify other US GAAP that require accounting at the trade date for certain contracts to purchase or sell securities.

29 EY note: This guidance is further discussed in sections 6.3 and 6.5.1.
Excerpt from Accounting Standards Codification

Sale of a Participating Interest

860-20-40-1A

Upon completion\(^{[28]}\) of a transfer of a participating interest that satisfies the conditions in paragraph 860-10-40-5 to be accounted for as a sale, the transferor (seller) shall:

- Allocate the previous carrying amount of the entire financial asset between both of the following on the basis of their relative fair values at the date of transfer:
  1. The participating interests sold
  2. The participating interest that continues to be held by the transferor.
- Derecognize the participating interest(s) sold
- Apply the guidance in paragraphs 860-20-25-1 and 860-20-30-1 on recognition and measurement of assets obtained and liabilities incurred in the sale\(^{[30]}\)
- Recognize in earnings any gain or loss on the sale
- Report any participating interest(s) that continue to be held by the transferor as the difference between the following amounts measured at the date of transfer:
  1. The previous carrying amount of the entire financial asset
  2. The amount derecognized.

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**Accounting for transfers that qualify as sales**

Upon completion of a transfer of an entire financial asset, group of entire financial assets or a participating interest that qualifies for sale accounting, the transferee initially recognizes, in accordance with ASC 860-20-30-2, all assets obtained and any liabilities incurred at fair value.

At the date a transfer qualifies as a sale,\(^{[31]}\) the transferor performs each of the following steps:

**Step 1** Derecognize from its balance sheet the transferred financial asset(s) or participating interests\(^{[32]}\) in an entire financial asset. For sales of participating interests, the portion of the entire financial asset derecognized is allocated between the participating interests sold and the participating interest that continues to be held by the transferor on the basis of their then relative fair values.

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\(^{[28]}\) EY note: This guidance is further discussed in sections 6.3 and 6.5.1.

\(^{[30]}\) The requirements for sale accounting are specified in ASC 860-10-40-5 and are discussed in Chapter 3 through Chapter 5.

\(^{[32]}\) The criteria of a participating interest are outlined in ASC 860-10-40-6A and discussed further in Chapter 2, *Unit of account*. 
The carrying value of the financial assets (or participating interests) sold includes any related allowance for loan losses or doubtful accounts, deferred costs and fees as determined under ASC 310-20, Receivables — Nonrefundable Fees and Other Costs, and unamortized premiums and discounts. As a result, any amounts in other comprehensive income related to the transferred financial assets (e.g., available-for-sale debt securities) or any premiums (or discounts) that were not fully amortized (or accreted) will be recognized in earnings at the date of transfer. If the transferred financial asset is a participating interest, only the portion of the unrealized gain or loss in other comprehensive income or unamortized (unaccreted) premium (discount) relating to the portion of the asset sold would be recognized in earnings. The proportion of these amounts recognized in earnings would equal the proportion of the financial asset derecognized.

Step 2 Initially recognize proceeds from sale (i.e., assets obtained and liabilities incurred — see ASC 860-20-25-1 through 25-4) at fair value (ASC 860-20-30-1). Proceeds include any beneficial interests (discussed further below) obtained by the transferor in exchange for the transferred financial assets as well as other forms of continuing involvement with the transferred financial assets (e.g., servicing asset or liability, guarantees). However, any participating interest retained by the transferor is not considered proceeds and thus is not re-measured at fair value. Instead, the carrying amount of the participating interest retained by the transferor is the difference between the previous carrying amount of the entire financial asset and the amount derecognized in Step 1.

Step 3 Recognize a gain or loss based on the difference between the net proceeds received (as determined in Step 2) and the carrying value of the financial asset(s) sold (as determined in Step 1). A transferor cannot elect to defer any portion of a gain or loss resulting from the sale of financial assets or participating interests. See examples in sections 6.5.4.1 and 6.5.4.2.

There is diversity in practice with respect to the unit of account when a loan is made and a premium is paid for inseparable, concurrently entered into, third-party credit guarantees (e.g., guarantee premiums paid to the Small Business Administration (SBA) for loans that qualify under the SBA program). That is, some lenders account for the guarantee premium as a separate asset, while others include the premium for the guarantee in the carrying value of the loan. We believe either approach is acceptable as long as that accounting policy is applied consistently. If the reporting entity accounts for the third-party guarantee as a separate asset, all or a pro-rata portion of the carrying value of that guarantee should be included in the transferor’s calculation of gain or loss on sale when a transferor sells an entire financial asset, or a participating interest in an entire financial asset, that is guaranteed. See Illustration 6-6 in section 6.5.4.2 for an example of the gain or loss calculation when the guarantee premium is included in the carrying value of the loan.


### 6.3.1 Transaction costs

**Excerpt from Accounting Standards Codification**

**860-20-35-10**

Transaction costs relating to a sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss. Transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. In a credit card securitization, however, some of the transaction costs incurred at the outset relate to the future sales that are to occur during the revolving period, and thus can qualify as an asset.

In many transfers of financial assets an entity incurs transaction costs, which must be considered in the gain or loss calculation when the transfer results in sale accounting, unless some of the costs incurred relate to future sales. To the extent the upfront transaction costs relate to future sales to occur during the revolving period of a securitization transaction (e.g., credit card securitizations), the cost should be deferred and expensed upon the earlier of (a) the completion of future related transactions or (b) the date the entity determines no future benefits can be derived from the deferred costs. These costs may be significant when the transactions are complex and involve the assistance of external advisors, as is typical in securitization transactions. Such costs typically include:

- Lawyers’ fees for drafting the prospectus and prospectus supplement
- Accountants’ fees for attestation work on collateral
- Consultants’ fees for loan file reviews
- Rating agencies’ fees to rate the securities being offered
- Costs to print the prospectus, prospectus supplement and other documents
- Fees paid to the SEC to register the transaction
- Other administrative costs limited to direct incremental expenses

In transfers of financial assets that do not meet the conditions for sale accounting in ASC 860-10-40-5, the transactions are accounted for as secured borrowings (see section 6.4 for further information). ASC 835-30-45-3 states that debt issuance costs “shall be reported in the balance sheet as deferred charges.” Therefore, debt issuance costs, such as the costs described above, should be deferred and amortized using the interest method over the life of the debt to which they relate (i.e., the term of the secured borrowing).

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34 Because transfers involving non-interest bearing financial assets (e.g., factoring arrangements involving sales of future trade receivables) will generally be sold at an accounting loss, transaction costs should be charged to expense as incurred.
6.4 Accounting for transfers that fail the conditions for sale accounting

Excerpt from Accounting Standards Codification

Secured Borrowing and Collateral – Recognition
860-30-25-2

The transferor and transferee shall account for a transfer as a secured borrowing with pledge of collateral in either of the following circumstances:

a. If a transfer of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset does not meet the conditions for a sale in paragraph 860-10-40-5

b. If a transfer of a portion of an entire financial asset does not meet the definition of a participating interest.

The transferor shall continue to report the transferred financial asset in its statement of financial position with no change in the asset’s measurement (that is, basis of accounting).

Refer to Chapter 8, Secured borrowings and collateral, for further guidance on accounting for failed sale transactions.

6.5 Proceeds from sales of financial assets

An important step in accounting for transfers of financial assets (or participating interests in entire financial assets) that qualify as sales is identifying the resulting assets obtained and liabilities incurred (if any). These assets and liabilities are collectively referred to as proceeds, which the ASC Master Glossary defines as cash, beneficial interests, servicing assets, derivative instruments, or assets that are obtained in a transfer of financial assets, less any liabilities incurred. Proceeds include any separately recognized servicing liabilities and recourse obligations.

In some transactions, various elements of proceeds are bundled into a single retained interest. For example, an entity may sell a group of entire financial assets and obtain as part of the proceeds a single interest that includes characteristics of both an interest-only strip and a recourse agreement. In this case, we believe the transferor has a single beneficial interest whose value should be determined by considering all of its various elements.

6.5.1 Initial measurement

ASC 860-20-30-1 requires that all proceeds be initially measured at fair value in accordance with the principles of ASC 820, Fair Value Measurement. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and therefore represents a market-based exit price. As such, the objective of the fair value measurement is to determine the price at which willing market participants would transact for the proceeds at the measurement date (considering the market conditions that exist at that date), irrespective of the transferor’s actual intention or ability to dispose of the proceeds.

Many forms of proceeds associated with transfers of financial assets accounted for as sales will not be traded in active markets. Examples include certain beneficial interests representing subordinated or residual interests in non-readily-obtainable assets and performance guarantees. ASC 820 provides a list of factors that may indicate when a market is not active and includes additional guidance for measuring fair value in these situations. The guidance indicates that all valuation techniques that are appropriate and for which sufficient data is available should be used to measure fair value. Additionally, those techniques should maximize the use of observable inputs and minimize the use of unobservable inputs.
For example, a market approach such as matrix pricing may be useful in measuring the fair value of certain proceeds (e.g., beneficial interests representing senior shares of interest in readily obtainable assets) when transaction data for comparable proceeds is available.

In many instances, the use of valuation techniques under an income approach, such as discounted cash flow models, option pricing models, or option-adjusted spread models, will be needed to measure the fair value of certain proceeds in markets that are not active. These valuation techniques should incorporate all of the factors and assumptions that market participants would consider in determining a current (i.e., as of the measurement date) exit price for the proceeds, including assumptions about risk and uncertainty. Depending on the complexity of the proceeds being measured, a valuation specialist may be needed. Refer to our Financial Reporting Developments publication, *Fair value measurement*, for further guidance.

### 6.5.2 Subsequent measurement

Although ASC 860 requires all proceeds to be initially recognized at their fair values, it generally is silent on the appropriate subsequent measurement of those proceeds. With the exception of financial assets subject to prepayment and servicing assets and servicing liabilities, the subsequent measurement of proceeds will be based on other applicable accounting guidance.

#### 6.5.2.1 Financial assets subject to prepayment

**Excerpt from Accounting Standards Codification 860-20-35-2**

Financial assets, except for instruments that are within the scope of Subtopic 815-10, that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available for sale or trading under Topic 320. Examples of such financial assets include, but are not limited to, interest-only strips, other beneficial interests, loans, or other receivables. Interest-only strips and similar interests that meet the definition of securities are included in the scope of that Topic. Therefore, all relevant provisions of that Topic (including the disclosure requirements) shall be applied.

Certain prepayment features embedded in financial assets such as interest-only strips may expose their holders to the possibility of not recovering substantially all of their recorded investments. While the term “substantially all” is not defined in ASC 860, it has been defined elsewhere in US GAAP (e.g., ASC 840, *Leases*). As a result of its use in other US GAAP, “substantially all” is generally interpreted in practice to mean 90% of the recorded investment.

Financial assets in the scope of ASC 860-20-35-2 should subsequently be remeasured at fair value, changes in which are recognized either in the statement of operations (if classified as trading) or other comprehensive income (if classified as available for sale).

**Excerpt from Accounting Standards Codification 860-20-35-3**

Interest-only strips and similar interests that are not in the form of securities are not within the scope of Topic 320 but shall be measured like investments in debt securities classified as available for sale or trading. In that circumstance, all of the measurement provisions of that Topic, including those addressing recognition and measurement of impairment, shall be followed. However, other provisions of that Topic, such as those addressing disclosures, are not required to be applied. Paragraph 320-10-15-9 explains that, for debt securities within its scope, Subtopic 325-40 provides incremental guidance on accounting for and reporting discount and impairment.
ASC 860-20-35-4 clarifies that the requirement in ASC 860-20-35-2 does not apply to situations in which events that are not the result of contractual provisions, such as borrower default or changes in the value of an instrument’s denominated currency relative to the entity’s functional currency, cause the holder not to recover substantially all of its recorded investment.

For example, an investment denominated in euros by an entity with a US dollar functional currency would not be subject to the requirements of ASC 860-20-35-2 if the contract requires that substantially all of the invested euros be repaid. However, a note for which the repayment amount is indexed to the creditworthiness of a party other than the issuer is subject to the provisions of ASC 860-20-35-2 because the event that might cause the holder to receive less than substantially all of its recorded investment is based on a contractual provision, not on a default by the borrower (that is, the issuer of the note). That contractual provision indexes the payment terms of the note to a default by a third party unrelated to the issuer of the note. If that note is within the scope of ASC 815-10 the guidance of ASC 860-20-35-2 would not apply.

ASC 860-20-35-5 prohibits a financial asset that can be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment from being classified as held-to-maturity (i.e., measured at amortized cost) even if the investor concludes that prepayment or other forms of settlement are remote. The probability of prepayment or other forms of settlement that would result in the holder’s not recovering substantially all of its recorded investment is not relevant in determining whether the provisions of ASC 860-20-35-2 apply to those financial assets.

However, a loan that is not a debt security, that when initially purchased could be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, may be reclassified as held for investment later in its life, if the investor would recover substantially all if its recorded investment even if the investment was repaid. That is, the loan would no longer be required to be measured in accordance with the guidance in ASC 860-20-35-2 if both of the following conditions are met:

- It would no longer be possible for the holder not to recover substantially all of its recorded investment upon contractual prepayment or settlement
- The conditions for amortized cost accounting are met (e.g., ASC 310-10-35-47 and ASC 948-310-25-1)

However, upon reclassification from available-for-sale to held-for-investment, any pre-existing unrealized gains or losses would continue to be reported in other comprehensive income and should be amortized over the remaining life of the loan as an adjustment of its yield.

**Determining whether financial assets subject to prepayment risk are subject to the provisions of ASC 815**

Financial assets subject to prepayment, such as interest-only strips (IOs) and principal-only strips (POs), should be evaluated to determine whether they are subject to the derivative provisions of ASC 815. ASC 815 states that only the simplest separations of interest payments and principal payments qualify for the exemption from derivative accounting afforded to IOs and POs.

ASC 815-10-15-72 and 15-73 clarify that to be exempt, the strips must (1) represent the rights to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal repayment cash flows of that debt instrument and (2) do not incorporate any terms not present in the original debt instrument. For example, allocating a portion of the interest and principal cash flows of a debt instrument to compensate another entity for servicing the instrument would meet the exception if the servicing fee was not greater than adequate.

35 ASC 860-20-55-39 discusses whether a residual tranche debt security in a securitization of a financial asset can be classified as held-to-maturity.
compensation as defined by ASC 860. However, allocating a portion of the interest or principal cash flows to provide for servicing in an amount greater than adequate compensation would not meet the exception or for any other purpose would not meet the intended narrow nature of the scope exception.

ASC 815-15-25-11 requires that beneficial interests in securitization transactions be analyzed to determine whether they are freestanding derivatives in their entirety or whether they are hybrid financial instruments that contain embedded derivatives that would require bifurcation from the host contract. ASC 815 provides guidelines that an entity should follow when determining whether the beneficial interest contains an embedded derivative that requires bifurcation.

Refer to our ASC 815 Financial Reporting Developments publication, Derivative instruments and hedging activities, for further guidance on determining whether a financial asset contains an embedded derivative that requires bifurcation.

6.5.3 Examples of proceeds and subsequent measurement considerations

The following is a list of common types of proceeds resulting from transfers of financial assets that qualify as sales and a brief description of the subsequent accounting treatment.

6.5.3.1 Beneficial interests

The ASC Master Glossary defines beneficial interests as rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through
b. Premiums due to guarantors
c. Commercial paper obligations
d. Residual interests, whether in the form of debt or equity

Examples of beneficial interests include notes or investor certificates (commonly referred to as asset-backed securities), which represent claims to principal and interest collections on an underlying pool of assets. Another type of beneficial interest is an interest-only strip receivable, which is a contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation or other interest-bearing financial asset. Generally, the interest-only strip is held by the transferor and arises because the transaction is designed to generate cash flows in excess of those cash flows actually required to meet the minimum obligations of the senior asset-backed securities. Consequently, the interest-only strip represents a return of this excess cash flow.

Refer to Chapter 10, Securitizations, for additional information regarding securitizations and the types of beneficial interests that commonly result from such transactions.

Measurement at fair value

Determining the fair value of beneficial interests obtained as proceeds in transfers of financial assets accounted for as sales will most likely be based on a discounted cash flow analysis. The timing and amount of future cash flows for beneficial interests in securitizations are often uncertain, especially if those interests are subordinate to more senior beneficial interests and involve assets that are subject to prepayment or credit losses. Applying the discounted cash flow approach depends heavily on the performance assumptions of the underlying assets securitized.

36 Refer to section 7.3 for additional guidance on determining adequate compensation.
Estimates should consider current expectations based on market conditions. The prepayment, credit loss, discount and other rates used to arrive at an estimate of fair value should represent the rate that a market participant would use to determine the value of the beneficial interest in an orderly transaction. If possible, an entity should use a probability-weighted discounted cash flow approach. Under that approach, the entity would assign a probability of occurrence to each identified possible assumption (e.g., select several different possible prepayment speeds and assign a probability to each prepayment speed). It would then derive the fair value using the resulting probability-weighted cash flows. The use of probability-weighted cash flows is illustrated in ASC 820-10-55-13 through 55-20.

The estimated cash flows should be modeled in conformity with the design of the specific securitization structure so that they consider both the amount and timing of cash payments to the beneficial interest holder. As such, the fair value estimate should be tailored for various structural aspects that could affect the value. An example of a feature of a securitization that would require tailoring of the valuation model would include cash retention triggers upon achieving certain levels of delinquency or default in the underlying portfolio. Such triggers typically provide for the retention of additional cash within the securitization vehicle for a longer period of time, thereby slowing the payment of cash to the holders of subordinated interests.

Prepayment and net loss assumptions should consider all available information and should be tailored for the characteristics of the underlying portfolio and current market conditions. The mix of contract interest rates, loan-to-value ratios, the mix of fixed versus floating interest rate instruments, and credit scores all affect fair value. Prepayment assumptions should be based on forward yield curves rather than spot rates and loss assumptions should consider, among other things, the servicing and underwriting history of the issuer.

Valuation assumptions should be “forward-looking” and generally should not be based solely upon historical performance. Forward-looking assumptions should reflect any known trends or economic conditions that may differ from historical trends. For example, if prepayment rates typically vary during certain months of the year, this variance should be considered in determining the appropriate prepayment assumption to use in valuation models. To illustrate, consider prepayment rates on credit card receivables. Typically, credit card balances increase during the fourth calendar quarter of the year due to holiday spending and decrease during the first calendar quarter of the year as customers pay down their balances. As such, it is generally not appropriate to use an average of the fourth quarter prepayment rates as the prepayment assumption in a 31 December valuation of credit card interests obtained by the transferor in a sale. That prepayment rate would not reflect the prepayment rate expected in the first quarter of the following year.

Additional factors that should be considered when deriving net credit loss assumptions for measuring fair value include trends in amount and timing of recoveries and collectability of interest on defaulted receivables.

The valuation considerations discussed above are not meant to be all-inclusive, but are provided to highlight some of the common issues encountered when performing the valuation of beneficial interests created through the securitization process.
Subsequent measurement

Balance sheet classification and measurement of beneficial interests in securitized financial assets are generally in the scope of ASC 320, Investments – Debt and Equity Securities. ASC 325-40, Investments – Other – Beneficial Interests in Securitized Financial Assets, provides income recognition guidance for certain beneficial interests that are debt securities, or are required to be accounted for like debt securities, that are supported by securitized financial assets with contractual cash flows. Beneficial interests that are of high credit quality and cannot be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment are outside the scope of ASC 325-40 and would follow ASC 320-10, Investments – Debt and Equity Securities.

Pursuant to ASC 325-40-35-1, an entity must prospectively adjust the yield used to recognize interest income for changes in estimated future cash flows since the last evaluation date (typically at each financial reporting date). As such, excess future cash flows are recognized using the effective yield method. ASC 325-40-35-2 further states that the recognition of interest income is the same whether the instrument is classified as held to maturity, available-for-sale or trading.

If the beneficial interest is accounted for under the fair value option (i.e., ASC 825-10-15-4) or is otherwise required to be accounted for as a derivative (i.e., ASC 815-10-15-83), an entity must report all changes in the fair value of the beneficial interest in earnings at each subsequent reporting date. For income recognition purposes, beneficial interests classified as trading are included in the scope of ASC 325-40-15-7 because certain industries (such as banks and investment companies) report interest income as a separate line item in their income statements, even though the investments are accounted for at fair value.

If the fair value of the beneficial interest is below the investment’s reference amount, an entity must determine whether that decline is other than temporary. An other-than-temporary impairment (OTTI) is considered to have occurred when, based on current information and events, there has been an adverse change in the timing or amount of cash flows expected to be collected. An OTTI also exists when the holder intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell the beneficial interest or more likely than not will be required to sell the beneficial interest before recovery of its amortized cost basis less any current-period credit loss, the OTTI should be recognized in earnings.

The impairment is equal to the entire difference between the investment’s amortized cost basis and its fair value at the balance sheet date. If there is no intent to sell and it is not more likely than not the holder will be required to sell the beneficial interest before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment should be separated into two components. The amount representing the credit loss is recognized in earnings and the amount related to all other factors is recognized in other comprehensive income.

For beneficial interests in securitized financial assets subject to ASC 325-40, the amount of the credit loss is measured as the difference between the current amortized cost of the debt security and the new estimate of future discounted cash flows. The discount rate used in this determination is the current yield used to accrete the beneficial interest.

Refer to our Financial Reporting Developments publication, Certain investments in debt and equity securities, for further information.

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37 Refer to our Financial Reporting Developments publication, Derivative instruments and hedging activities, for further information.

38 The reference amount used to determine if an OTTI exists is the initial investment less cash received to date (both principal and interest), less OTTI recognized in earnings to date, plus the yield accreted to date.
6.5.3.2 Servicing assets and servicing liabilities

A servicing asset or servicing liability represents the servicing fees in excess (i.e., asset) or below (i.e., liability) adequate compensation. Adequate compensation represents the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, including the profit that would be demanded in the marketplace. Any servicing asset or servicing liability recognized as part of the sale must initially be measured at fair value.

Subsequent measurement

For subsequent measurement purposes, each identified class of servicing assets and liabilities is measured using either the amortization method or fair value measurement method. ASC 860-50-35 and Chapter 7, Servicing of financial assets, discuss the initial and subsequent measurement of servicing assets and servicing liabilities in further detail.

6.5.3.3 Derivatives

Securitizations often involve derivatives when the interest rate on the transferred financial assets is different than that of the asset-backed securities issued in the transaction (e.g., if the transferred assets pay a fixed interest rate and the asset-backed securities pay a floating rate). Often, the rating agencies will require that any interest rate mismatch be mitigated through an interest rate swap or other derivative instrument to obtain a favorable rating. Derivatives in a securitization transaction may be discrete (purchased separately) or embedded within the residual interest (subordinated interest or interest-only strip).

Examples of derivative financial instruments (either held or written) entered into concurrently with a transfer of financial assets include:

- **Swaps** – arrangements in which two parties agree to exchange periodic payments for the mutual benefit of the exchangers (examples include interest rate swaps – provisions that convert interest rates from fixed to variable and currency swaps – the exchange of the principal and interest in one currency for the principal and interest in another currency).

- **Put options** – contracts that allow the holder to sell a specified quantity of an underlying instrument (e.g., stock) to the writer of the contract at a fixed price during a given period. Put options include guarantee or recourse obligations that are further discussed in sections 6.5.3.4 and 6.5.3.5, respectively.

- **Call options** – contracts that allow the holder to buy a specified quantity of an underlying instrument (e.g., stock) from the writer of the contract at a fixed price for a given period (e.g., provisions that allow the transferor to repurchase the transferred financial assets).

- **Credit derivatives** – derivative instruments that have both of the following characteristics:39
  a. One or more of its underlyings are related to any of the following:
     1. The credit risk of a specified entity (or a group of entities)
     2. An index based on the credit risk of a group of entities
  b. It exposes the seller to potential loss from credit-risk-related events specified in the contract

Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options, and credit index products.

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39 As defined in the ASC Master Glossary.
Forwards – agreements between two parties to buy or sell an asset at a certain future time for a certain price agreed today (e.g., commitments to deliver additional receivables during the revolving periods of some securitizations – see ASC 860-20-55-29 through 55-31 below).

Excerpt from Accounting Standards Codification

Forward Contracts in Revolving-Period Securitizations

860-20-55

55-29 The requirement that all financial assets obtained and liabilities incurred by the transferor of a securitization that qualifies as a sale shall be recognized and measured as provided in this Subtopic includes the implicit forward contract to sell additional financial assets during a revolving period. Such a forward contract may become valuable or onerous to the transferor as interest rates and other market conditions change.

55-30 The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract’s value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

55-31 Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold.

Rights or obligations to reacquire transferred financial assets or beneficial interests may constrain the transferee’s ability to freely pledge or exchange the transferred financial assets (or beneficial interests) or permit the transferor to unilaterally cause the return of the transferred financial assets (or beneficial interests). In such instances, if the constraint or right to purchase the transferred assets provides the transferor with a more-than-trivial benefit, sale accounting would be precluded (refer to Chapters 4 and 5 for further information).

Subsequent measurement

Under the guidance of ASC 815, Derivatives and Hedging, all discrete and embedded derivatives that require bifurcation and separate accounting are subsequently measured at fair value. Embedded derivatives should be separated from the host contract (e.g., beneficial interest) and accounted for as derivative instruments only if certain criteria are met (ASC 815-15-25-1). These criteria are:

> The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

> The hybrid instrument is not remeasured at fair value through earnings under otherwise applicable US GAAP.

> A separate instrument with the same terms as the embedded derivative would, pursuant to ASC 815-10-15, be a derivative instrument subject to the requirements of ASC 815-10.
Further, an entity that initially recognizes a hybrid financial instrument that is required to be separated into a host contract and a derivative instrument under ASC 815-15-25-1 may irrevocably elect to subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). A hybrid financial instrument that is not required to be separated between a host contract and a derivative instrument because it does not meet the criteria listed above will continue to follow the appropriate accounting for the hybrid instrument (e.g., investment accounting as an available-for-sale security).

Refer to our Financial Reporting Developments publication, *Derivative instruments and hedging activities*, for further information.

### 6.5.3.4 Guarantees

In order to provide enhanced credit protection, a transferor or third party may guarantee the performance of the transferred asset(s). Any asset performance guarantee provided in the transaction is accounted for under ASC 460, *Guarantees*.

Because the accounting for credit enhancement(s) may vary depending on how the specific arrangement is structured, it is necessary to understand the terms of the contractual arrangements. Arrangements referred to as “financial guarantees” and “insurance contracts” that relate to an underlying borrower’s credit event should be evaluated to determine whether the arrangements qualify for the financial guarantee scope exception in ASC 815-10-15-58 or as a derivative contract that must be accounted for under ASC 815.

**Subsequent measurement**

ASC 460-10-35 does not provide comprehensive guidance on how the guarantor’s liability for its obligations under the guarantee should be measured after its initial recognition. A guarantee obligation should not be subsequently measured at fair value unless the use of that method is permitted under other US GAAP. For example, if the guarantee is a derivative (or the entity elects the fair value option), the obligation should be remeasured at fair value at each reporting date with changes in fair value reported through earnings. Conversely, if the guarantee meets the scope exception in ASC 815 and the entity does not elect the fair value option, other accounting guidance should be considered.

In those instances, the liability initially recognized by the guarantor is typically reduced (by a credit to earnings) in subsequent periods as the guarantor is released from risk under the guarantee. Depending on the nature of the guarantee, the guarantor’s release from risk has typically been recognized over the term of the guarantee using various methods described in ASC 460-10-35-2 (i.e., upon either expiration or settlement of the guarantee, a systematic and rational amortization method, or as the fair value of the guarantee changes). Any subsequent evidence that indicates the initial fair value measurement was understated should generally follow loss contingency accounting under ASC 450-20 and be recognized when such increased liability is probable and reasonably estimable.
6.5.3.5 Recourse obligations

Recourse is the right of a transferee (e.g., purchaser) to receive payment from the transferor (e.g., seller) for (a) failure of underlying borrowers to make payments when due, (b) the effects of prepayments or (c) adjustments resulting from defects in the eligibility of the underlying transferred financial assets or breach of standard representations and warranties. For example, the transferor may be required to:

- Make full or partial payment to the transferee if the underlying borrowers fail to pay when payment is due for a specified period of time (e.g., for the first three scheduled payments after the transfer date)
- Refund the premium paid by the transferee if a prepayment or default occurs within a specified period
- Make payments to the transferee if underwriting defects are determined to exist

In accordance with ASC 860-20-55-24, a transferor should initially measure at fair value any recourse obligations resulting from a sale of financial assets. In many instances, observable market prices or model inputs may not exist to estimate the fair value of these obligations. Accordingly, this may require the transferor to make its own assumptions about the assumptions that market participants would use in pricing the obligation. A starting point for these assumptions could be historical experience, adjusted to reflect expectations of future losses based on current market conditions. However, if relevant observable market data exists indicating that market participants would use different assumptions, the transferor should adjust its assumptions to incorporate that market information.

Subsequent measurement

Recourse obligations should be subsequently measured according to accounting pronouncements for measuring similar liabilities. Generally, ASC 450-20, Contingencies – Loss Contingencies, would apply. ASC 450-20 requires that a loss should be recorded only when it is probable and reasonably estimable. Once the obligation is measured, entities should regularly reassess credit enhancement agreements to determine the need to increase the recognized obligation (e.g., in the case of a recourse arrangement) or recognize an impairment (e.g., in the case of an investment in a subordinated beneficial interest issued by a securitization entity).

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40 Standard representations and warranties are defined in the ASC Master Glossary as representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date. Examples include representations and warranties about (a) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset, (b) the quality, accuracy, and delivery of documentation relating to the transfer and the underlying financial asset, and (c) the accuracy of the transferor’s representations in relation to the underlying financial asset. Representations and warranties generally are applicable for the life of the transferred financial assets and thus create an ongoing exposure for a transferor that must be considered in the initial and subsequent measurement of any liability.

41 Refer to our Financial Reporting Developments publication, Fair value measurement, for further discussion of measuring fair value.
Examples that illustrate the calculation of gain or loss

The transactions described below are assumed to meet all of the conditions for sale accounting in ASC 860-10-40-5, and portions retained by the transferor meet the requirements of a participating interest as defined in ASC 860-10-40-6A. It is also assumed that the transferor is not required to consolidate the transferee under the guidance of ASC 810. There is no assurance or presumption that such transactions would actually meet the conditions for derecognition and nonconsolidation.

6.5.4.1 Transfers of an entire financial asset or groups of entire financial assets

Illustration 6-1: Factoring of trade receivables

Company C, an auto supplier, needs to raise cash to fund its operations and improve its credit position with its lenders. Company C decides to sell $1 million in short-term (30 to 45 days) trade receivables to Finance Entity H through a factoring arrangement. Because the trade receivables are non-interest bearing, Company C sells them at a discount to face value. The discount rate, which in this instance is 5%, reflects the market return expected for investments of similar duration and credit quality. The factoring arrangement allows Company C to transfer the receivables on a nonrecourse basis. In other words, the receivables are sold outright to Finance Entity H, which assumes the full risk of collection, without recourse to Company C in the event of a loss. Company C’s debtors are directed to send payments to Finance Entity H.

Additional assumptions:

At the date of transfer, Company C has no allowance for doubtful collection established for the receivables, as its history suggests credit losses on accounts receivable have been immaterial.

Loss on sale calculation

\[
\begin{align*}
\text{Cash proceeds from factoring arrangement} & \quad \$ 950,000 \\
\text{Less: Carrying amount of receivable sold} & \quad 1,000,000 \\
\text{Loss on sale} & \quad (50,000)
\end{align*}
\]

Balance sheet comparison

\[
\begin{array}{ccc}
\hline
\text{Assets} & \text{Before} & \text{After} \\
\hline
\text{Cash} & \$100,000 & \$1,050,000 \\
\text{Trade receivables} & 1,000,000 & - \\
\hline
\text{Total assets} & \$1,100,000 & \$1,050,000 \\
\hline
\text{Liabilities} & & \\
\text{Bank loans} & \$650,000 & \$650,000 \\
\text{Accounts payable} & 300,000 & 300,000 \\
\hline
\text{Total liabilities} & 950,000 & 950,000 \\
\text{Equity} & 150,000 & 100,000 \\
\hline
\text{Total liabilities and equity} & \$1,100,000 & \$1,050,000 \\
\hline
\end{array}
\]

Other financial reporting consideration:

The loss on the sale would be recorded on the date of sale and included in the statement of operations.
Illustration 6-2: Transfers with proceeds of cash, beneficial interests and a recourse obligation

ABC Bank transfers a group of loans in their entirety with a carrying amount of $1,000,000 to a trust (ABC 2010-6 Trust, or the transferee). The transferee is an entity whose sole purpose is to engage in securitization or asset-backed financing activities. For tax and credit rating purposes, among other reasons, the transferee is constrained from selling or pledging the transferred loans. To finance the acquisition, ABC 2010-6 Trust issues three different classes of beneficial interests in the transferred loans: senior certificates with an aggregate fair value of $880,000, mezzanine certificates with an aggregate fair value of $165,000 and residual interests with an aggregate fair value of $55,000.

Investors in the beneficial interests issued by ABC 2010-6 Trust are not constrained from selling or pledging their beneficial interests. In exchange for the transferred loans, ABC Bank obtains 20% of the senior certificates issued by the trust and $924,000 in cash. ABC Bank undertakes no servicing responsibilities and assumes a limited recourse obligation to repurchase delinquent loans. The initial fair value of the limited recourse obligation is $30,000.

<table>
<thead>
<tr>
<th>Net proceeds received by ABC Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Plus: Senior certificates</td>
</tr>
<tr>
<td>Less: Assumed recourse obligation</td>
</tr>
<tr>
<td>Net proceeds</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gain on sale calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
</tr>
<tr>
<td>Gain on sale</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal entry recorded by ABC Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Senior certificates</td>
</tr>
<tr>
<td>Loans</td>
</tr>
<tr>
<td>Recourse obligation</td>
</tr>
<tr>
<td>Gain on sale</td>
</tr>
</tbody>
</table>

Note: To record transfer of loans accounted for as a sale

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42 The option held by ABC 2010-6 Trust that entitles it to put back delinquent loans to ABC Bank does not preclude ABC Bank from derecognizing the transferred loans because exercise of the put option is conditional and beyond ABC Bank’s control. Additionally, it is assumed that the extent of the guarantee does not prevent the transferor from meeting the legal isolation requirements for sale accounting.

43 ASC 860-20-30-1 requires that all proceeds, including beneficial interests obtained, and reductions from proceeds, including guarantees or recourse obligations, be initially measured at fair value.

44 Represents the initial fair value of the recourse obligation ABC Bank is required to recognize under ASC 860 and ASC 460, Guarantees.
Illustration 6-3: Transfers with proceeds of cash, derivatives and other liabilities

The following example is adopted from ASC 860-20-55-43 through 55-45, Recording Transfers with Proceeds of Cash, Derivative Instruments, and Other Liabilities:

Entity A transfers entire loans with a carrying amount of $1,000 to an unconsolidated securitization entity and receives proceeds with a fair value of $1,030, and the transfer is accounted for as a sale. Entity A undertakes no obligation to service and assumes a limited recourse obligation to repurchase delinquent loans. Entity A agrees to provide the transferee a return at a variable rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

This example has the following assumptions.

<table>
<thead>
<tr>
<th>Fair Value</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
</tr>
<tr>
<td>Interest rate swap asset</td>
<td>40</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net proceeds</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Interest rate swap asset</td>
<td>40</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,030</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gain on sale</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$1,030</td>
</tr>
<tr>
<td>Less: Carrying amount of loans sold</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$30</td>
</tr>
</tbody>
</table>

Journal entry recorded by Entity A

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,050</td>
</tr>
<tr>
<td>Interest rate swap asset</td>
<td>40</td>
</tr>
<tr>
<td>Loans</td>
<td>$1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>30</td>
</tr>
</tbody>
</table>

*Note:* To record transfer of loans accounted for as a sale.
Illustration 6-4: Banker’s acceptance transaction

Banker’s acceptances provide a way for a bank to finance a customer’s purchase of goods from a vendor for periods usually not exceeding six months. Under an agreement between the bank, the customer, and the vendor, the bank agrees to pay the customer’s liability to the vendor upon presentation of specified documents that provide evidence of delivery and acceptance of the purchased goods. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. The vendor typically sells the accepted draft at a discount either to the accepting bank or in the marketplace.

In accordance with ASC 860-10-55-65, an accepting bank that obtains a risk participation should not derecognize the liability for the banker’s acceptance because the accepting bank is still primarily liable to the holder of the banker’s acceptance even though it benefits from a guarantee of reimbursement by a participating bank. The accepting bank should not derecognize the receivable from the customer because it has not transferred the receivable. Rather, it controls the benefits inherent in that receivable and it is still entitled to receive payment from the customer. The accepting bank should, however, record the guarantee purchased, and the participating bank should record a liability for the guarantee issued. Consider the following example.

An accepting bank assumes a liability to pay a customer’s vendor and obtains a risk participation from another bank. The face value of the draft provided to the vendor is $1,000 for 90 days. The Bank charges commission of $25 (assumed at an annual rate of 10%). The Bank also pay fee of $10 for obtaining the risk participation.

The banks would make the following journal entries:

**Journal Entries for Accepting Bank**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At issuance of acceptance:</strong></td>
<td></td>
</tr>
<tr>
<td>Receivable from customer</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Cash</td>
<td>25</td>
</tr>
<tr>
<td>Time draft payable to vendor</td>
<td></td>
</tr>
<tr>
<td>Deferred acceptance commission revenue</td>
<td>25</td>
</tr>
<tr>
<td><strong>At purchase of risk participation from a participating bank:</strong></td>
<td></td>
</tr>
<tr>
<td>Guarantee purchased</td>
<td>10</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
</tr>
<tr>
<td><strong>Upon presentation of the accepted time draft:</strong></td>
<td></td>
</tr>
<tr>
<td>Time draft payable to vendor</td>
<td>1,000</td>
</tr>
<tr>
<td>Deferred acceptance commission revenue</td>
<td>25</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Acceptance commission revenue</td>
<td></td>
</tr>
<tr>
<td><strong>Upon collection from the customer (or the participating bank, if the customer defaults):</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Guarantee expense</td>
<td>10</td>
</tr>
<tr>
<td>Receivable from customer</td>
<td>1,000</td>
</tr>
<tr>
<td>Guarantee purchased</td>
<td>10</td>
</tr>
</tbody>
</table>
Journal Entries for Participating Bank

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10</td>
</tr>
<tr>
<td>Guarantee liability</td>
<td>$10</td>
</tr>
</tbody>
</table>

Upon issuing the risk participation:

Upon payment by the customer to the accepting bank:

Guarantee liability

Guarantee revenue

Or:

In the event of total default by the customer:

Guarantee loss

Guarantee liability

Cash (paid to accepting bank)

6.5.4.2 Transfers of participating interests

Illustration 6-5: Recording transfers of participating interests

Bank X originates a loan to Company ABC on 1 February 2010. The loan is for $200,000, has a stipulated interest rate of 6.5%, becomes due on 31 January 2020 and is collateralized by Company ABC’s property, plant and equipment. Principal and interest are paid monthly. Fees earned by Bank X in connection with originating this loan, net of costs incurred, totaled $1,500. In accordance with ASC 310-20-25-2, net origination fees are deferred and reported as part of the carrying value of the loan (i.e., carrying value at inception equals $198,500 ($200,000 loan − $1,500 net origination fees)). The net origination fees will be amortized over the life of the loan.

During December 2010, Bank X decides to sell a portion of its loans in order to increase its cash position. On 31 December 2010, Bank X reaches an agreement with Investment Group to sell a 40% participating interest in the Company ABC loan.

Additional assumptions:

- At the time of sale, the carrying value and fair value of the entire loan recorded on Bank X’s balance sheet are $185,290 and $192,592, respectively. The fair value of the Company ABC loan is higher than the carrying amount because market interest rates for comparable loans (e.g., comparable credit quality and duration) have fallen to 5.9%.
- The amount paid by Investment Group for the 40% participating interest is $77,037 and represents fair value.
- Bank X retains servicing rights and in exchange is entitled to a fee of 35 basis points.
- The transaction is assumed to qualify for sale accounting. No servicing asset or servicing liability is initially recognized because Bank X estimates that the servicing fee is just adequate to compensate it for its servicing responsibilities.
To calculate the gain or loss on sale, Bank X allocates the carrying amount between the participating interest sold to Investment Group and the participating interest that it continues to hold. This allocation is based on the relative fair values at the date of transfer. The participating interest that Bank X continues to hold is recognized as the difference between the previous carrying amount and the amount derecognized. That is, the portion of the loan retained continues to be recognized on Bank X’s balance sheet at its allocated book value because control has not been surrendered.

The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

### Allocated carrying amount based on relative fair values

<table>
<thead>
<tr>
<th>Participating Interest</th>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Four-tenths participating interest sold</td>
<td>$77,037</td>
<td>40%</td>
<td>$74,116(A)</td>
</tr>
<tr>
<td>Six-tenths participating interest that continues to be held by Bank X</td>
<td>$115,555</td>
<td>60%</td>
<td>$111,174(B)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$192,592</strong></td>
<td><strong>100%</strong></td>
<td><strong>$185,290</strong></td>
</tr>
</tbody>
</table>

**Notes:**

(A) Represents the carrying value of the loan at the time of sale multiplied by the ratio of the fair value of the participating interest (PI) sold relative to the sum of the PI sold and the PI retained (i.e., $185,290 x ($77,037 / ($77,037 + $115,555)) or $185,290 x 40%).

(B) Represents the carrying value of the loan at the time of sale multiplied by the ratio of the fair value of the participating interest (PI) retained relative to the sum of the PI retained and the PI sold (or $185,290 x ($115,555 / ($115,555 + $77,037)) or $185,290 x 60%).

### Gain on sale calculation

- Proceeds: $77,037
- Allocated carrying amount of loan sold: $74,116
- Gain on sale: $2,921

### Journal entry recorded by Bank X

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$77,037</td>
</tr>
<tr>
<td>Loan</td>
<td>74,116</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>2,921</td>
</tr>
</tbody>
</table>

**Note:** To record transfer of a portion of a loan accounted for as a sale

---

**Illustration 6-6: Transfers of participating interests involving third-party guarantees**

On 1 January 2010, Bank A originates a ten-year loan to Company B (the Borrower) with a contractual principal amount and interest rate of $300,000 and 7%, respectively. Fees earned by Bank A in connection with originating this loan, net of costs incurred, totaled $2,000. Bank A obtains a third-party guarantee from the Small Business Administration (SBA) for 75% of the loan’s contractual payments in the event the borrower defaults. The guarantee is attached to the loan, and the loan with the attached guarantee is transferable. Bank A accounts for the guarantee as part of the loan basis, consistent with its accounting policy. A one-time guarantee fee equal to 3% of the total amount guaranteed (i.e., 3% of $225,000, or $6,750) is assessed by and paid to the SBA at the loan’s origination.

Shortly after its origination, Bank A transfers the guaranteed portion (i.e., 75% of the loan) to Bank C and retains servicing rights.
Additional assumptions:

- The transaction meets all of the criteria to qualify as a participating interest\(^{45}\) and each of the derecognition criteria of ASC 860 to be accounted for as a sale.
- A servicing asset of $3,161 is initially recognized because Bank A estimates that the servicing fee (100 basis points\(^{46}\)) is more than adequate compensation, but not significantly above an amount that would fairly compensate a substitute service provider, should one be required.
- Except for standard representations and warranties, Bank A provides no recourse to Bank C.
- Market interest rates have not changed from the time of origination to the time of sale.
- The price paid by Bank C for its participating interest is $230,839, which is assumed to be fair value.
- The estimated fair value of the participating interest retained by Bank A is $75,000.

To calculate the gain or loss on sale, Bank A allocates the carrying amount of the loan between the participating interest sold to Bank C and the participating interest that it continues to hold. This allocation is based on the relative fair values at the date of transfer. In this example, the premium that Bank C pays to Bank A primarily relates to the SBA guarantee. Excluding the guarantee, the relative fair values of the portion of the loan sold and the portion retained would also differ because the portion of the loan sold is subject to a servicing fee, which is considered to be above adequate compensation, but not significantly above.\(^{47}\)

The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

<table>
<thead>
<tr>
<th>Fair value</th>
<th>Percentage of total fair value</th>
<th>Allocated carrying amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>75% Participating interest sold</td>
<td>$230,839</td>
<td>75.48%</td>
</tr>
<tr>
<td>25% Participating interest that continues to be held by Bank A</td>
<td>75,000</td>
<td>24.52</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$305,839</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

**Notes:**

- \(^{(A)}\) Represents the carrying value of the loan ($300,000 [loan amount] – $2,000 [net origination fees] + $6,750 [guarantee fee]) = $304,750 x 75.48% [percentage of fair value] or $230,025.
- \(^{(B)}\) Represents the carrying value of the loan ($300,000 [loan amount] – $2,000 [net origination fees] + $6,750 [guarantee fee]) = $304,750 x 24.52% [percentage of fair value] or $74,725.

**Gain on sale calculation**

**Proceeds:**

- **Cash received on sale of participating interest** | $230,839
- **Servicing asset** | 3,161
- **Total proceeds** | 234,000

**Less: Allocated carrying amount of loan sold**

| (230,025) |

**Gain on sale**

| $3,975 |

---

\(^{45}\) ASC ASC 860-10-55-17M clarifies that third-party guarantees are excluded from the determination of what constitutes a participating interest.

\(^{46}\) Terms may vary based on the specific SBA program.

\(^{47}\) The example assumes that the 100 basis point servicing fee does not entitle a servicer to an amount that would be significantly above adequate compensation. There is no assurance or presumption that such a fee would actually meet the requirements of a participating interest. Any evaluation of the adequacy of servicing fees should be based on the specific facts and circumstances.
Journal entry recorded by Bank A

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $230,839</td>
<td>$230,025</td>
</tr>
<tr>
<td>Servicing asset 3,161</td>
<td></td>
</tr>
<tr>
<td>Loans $230,025</td>
<td></td>
</tr>
<tr>
<td>Gain on sale 3,975</td>
<td></td>
</tr>
</tbody>
</table>

Note: To record transfer of a portion of a loan accounted for as a sale and recognize an asset for servicing rights retained

Other financial reporting consideration:
The 25% of the original loan that remains on Bank A’s statement of financial position has an allocated carrying amount of $74,725. This amount, assuming all payments are made as agreed, will be accreted to $75,000, which represents the 25% of the contractual payments due from Company B.

Illustration 6-7: Transfers of participating interests in sales-type lease receivables

Company A manufactures equipment with an estimated economic life of 5 years and leases equipment to Company B for a period of 4 years at $250,000 per year. Company A subsequently sells an 80% participating interest in the minimum lease payments to Investor X for $650,000. Company A retains servicing rights and receives a servicing fee from Investor X. Company A retains a 100% interest in the unguaranteed residual value of the leased equipment. Because the unguaranteed residual value is not a financial asset, it is excluded from the analysis of whether the transfer of the 80% participating interest in the minimum lease payments meets the definition of a participating interest.

Additional assumptions:
- The lease represents a sales-type lease.
- The transaction meets all of the criteria to qualify as a participating interest and each of the derecognition criteria of ASC 860 to be accounted for as a sale.
- No servicing asset or servicing liability is initially recognized because Company A estimates that the servicing fee is just adequate to compensate it for its servicing responsibilities.
- Market interest rates for comparable leases (e.g., comparable credit quality and duration) have decreased since inception of the lease.

48 This transaction would also meet the definition of a participating interest if Company A, at lease inception, obtained a third-party guarantee on the estimated residual value of the equipment. Because the residual value would be guaranteed by a third-party, the guarantee would be excluded from the determination of whether a portion of the gross investment in lease receivables meets the definition of a participating interest. See section 2.3.3 for additional information regarding the effect of recourse provisions on participating interests and questions 2-1 and 2-2 in Chapter 2, Unit of account, for further discussion of the unit of account related to investments in lease receivables.
The allocation of the participating interests sold and retained, the calculation of the gain recorded on sale and related journal entries are outlined in the tables below:

### Carrying amounts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum lease payments</td>
<td>$800,000</td>
</tr>
<tr>
<td>Unearned income related to minimum lease payments</td>
<td>$200,000</td>
</tr>
<tr>
<td>Gross investment in minimum lease payments</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Unguaranteed residual value</td>
<td>$100,000</td>
</tr>
<tr>
<td>Unearned income related to unguaranteed residual value</td>
<td>$40,000</td>
</tr>
<tr>
<td>Gross investment in unguaranteed residual value</td>
<td>140,000</td>
</tr>
<tr>
<td>Total gross investment in financing lease receivable</td>
<td>$1,140,000</td>
</tr>
</tbody>
</table>

### Gain on sale calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds – cash received</td>
<td>$650,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>80% of carrying amount of gross investment in minimum lease payments</td>
<td>$800,000</td>
</tr>
<tr>
<td>80% of carrying amount of unearned income related to minimum lease payments</td>
<td>(160,000)</td>
</tr>
<tr>
<td>Net carrying amount of minimum lease payments sold</td>
<td>640,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

### Journal entry recorded by Company A

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$650,000</td>
<td></td>
</tr>
<tr>
<td>Unearned income</td>
<td></td>
<td>160,000</td>
</tr>
<tr>
<td>Lease receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain on sale</td>
<td></td>
<td>$800,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10,000</td>
</tr>
</tbody>
</table>

**Note:** To record sale of 80% of the minimum lease payments

---

**Regaining control of financial assets sold**

Under ASC 860, a transferred financial asset is considered to be repurchased if the transfer no longer qualifies for sale accounting. In general, the sale accounting criteria must continue to be met after the transfer in order to be accounted for as a sale. For example, a contingent call held by a transferor on previously sold financial assets may potentially become exercisable at a later date if the contingency is resolved and provides the transferor the unilateral right to reclaim the underlying asset. In that circumstance, obtaining control of the financial asset or group of financial assets is accounted for as if the assets were purchased anew.

Regaining control of previously derecognized financial assets raises several accounting issues, including:

- How the transferor should account for the previously sold assets for which control has been regained
- How the accounting differs if such assets are actually repurchased
- How the transferor should account for interests that continue to be held by the transferor when the underlying assets are re-recognized
- Whether any gain or loss should be recognized by the transferor when an event occurs that requires re-recognition of the previously sold assets
• Whether under any circumstances a loan loss allowance should initially be recorded for loans that do not meet the definition of a security when they are rerecognized

• How re-recognition of previously sold assets affects the accounting for the related servicing asset or servicing liability

• After the transferor has regained control of assets previously derecognized, whether the transferor should continue to separately account for interests that continue to be held in the original transaction

ASC 860-20-25 clarifies how the guidance in ASC 860-10-40-41 relates to those issues.

Excerpt from Accounting Standards Codification

860-20-25

25-8 Paragraph 860-10-40-41 explains that a change in law or other circumstance may result in a transferred portion of an entire financial asset no longer meeting the conditions of a participating interest (see paragraph 860-10-40-6A) or the transferor’s regaining control of transferred financial assets after a transfer that was previously accounted for as a sale, because one or more of the conditions in paragraph 860-10-40-5 are no longer met.

25-9 Such changes shall be accounted for in the same manner as a purchase of the transferred financial assets from the former transferee(s) in exchange for liabilities assumed unless they arise solely from either:

a. Consolidation of an entity involved in the transfer at a subsequent date (see paragraph 860-20-25-10)

b. A change in market prices (for example, an increase in price that moves into the money a freestanding call option on a non-readily-obtainable, transferred financial asset that was originally sufficiently out of the money that it was judged not to constrain the transferee).

See the related guidance beginning in paragraph 860-20-25-1.

25-10 After that change,[49] the transferor shall do all of the following:

a. Recognize in its financial statements those transferred financial assets together with liabilities to the former transferee(s) or beneficial interest holders of the former transferee(s).[50]

b. Not change the accounting for the servicing asset related to the previously sold financial assets. That is, even though the transferor has regained control over the previously sold assets, the cash flows from those assets will contractually be paid to the special-purpose entity, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because the transferor, as servicer, is still contractually required to collect the asset’s cash flows for the benefit of the special-purpose entity and otherwise service the assets, it shall continue to recognize the servicing asset and assess the asset for impairment if subsequently measured using the amortization method, as required by paragraph 860-50-35-9. Once a servicing asset is recognized it shall not be added back to the underlying asset. Even when the transferor has regained control over the underlying assets through an event that triggers a transferor to rerecognize previously transferred assets that were accounted for as having been sold, the related servicing asset shall continue to be separately recognized.

[49] EY note: That is, a change in circumstance that results in the transferor regaining control of assets previously accounted for as a sale (see ASC 860-20-25-8), unless the change results solely from circumstances described in ASC 860-20-25-9.

[50] EY note: ASC 860-20-40-3 indicates that the transferee would derecognize the transferred financial assets, as if it had sold the financial assets in exchange for a receivable from the transferor.
The accounting for the servicing asset or servicing liability related to previously sold financial assets does not change when the transferor regains control over those assets. However, if the previously derecognized financial assets are repurchased from the transferee (i.e., the transferee no longer owns the asset being serviced and receives no cash flows from the asset being serviced), the original servicing arrangement would cease to exist and the servicing asset or servicing liability would be derecognized. In other words, the servicing asset or servicing liability would be recombined with the underlying assets. The accounting is similar if the transferee is subsequently consolidated by the transferor (i.e., the related servicing asset or servicing liability is no longer separately recognized in the transferor’s consolidated financial statements). Although the servicing contract may still exist, we believe the effects of ASC 860-20-25-10 would be eliminated through the normal elimination of intercompany transactions in consolidation.

### Excerpt from Accounting Standards Codification

**860-20-25-10**

c. Continue to account for the transferor’s interests in those underlying financial assets apart from any rerecognized financial assets. That is, the transferor’s interests shall not be combined with and accounted for with the rerecognized financial assets. Example 10 (see paragraph 860-20-55-83) illustrates this guidance. However, a subsequent event that results in the transferor reclaiming those financial assets from the transferee, for example, the exercise of a removal-of-accounts provision or the consolidation by the transferor of the securitization entity in accordance with applicable GAAP, including the Variable Interest Entities Subsections of Subtopic 810-10, would result in a recombination of the transferor’s interests with the underlying financial assets.

For guidance on consolidation, which is relevant to determining whether a transferor must consolidate an entity involved in a transfer that was accounted for as a sale, see Topic 810.

When control is regained over previously sold assets, the transferor should recognize such assets at fair value with a corresponding payable to the transferee or the transferee’s beneficial interest holders. However, before assets are actually reclaimed or consolidation of the transferee occurs, to the extent the transferor continues to hold beneficial interests in the previously sold assets, we believe the amount of the financial assets re-recognized is limited to the extent of the amounts owed to third-parties. Additionally, in accordance with ASC 860-20-35-9, beneficial interests that the transferor continues to hold should be periodically evaluated for possible impairment, including at the time control is regained over the underlying financial assets.

### Excerpt from Accounting Standards Codification

**860-20-25**

25-12 Upon application of paragraph 860-20-25-10, no gain or loss shall be recognized in earnings with respect to any of the transferor’s beneficial interests. A gain or loss may be recognized upon the exercise of a removal-of-accounts provision or similar contingent right with respect to the repurchased transferred financial assets that were sold if the removal-of-accounts provision or similar contingent right held by the transferor is not accounted for as a derivative instrument under Subtopic 815-10 and is not at the money, resulting in the fair value of those repurchased assets being greater or less than the related obligation to the transferee.

25-13 Under no circumstances shall a loan loss allowance be initially recorded for loans that do not meet the definition of a security when they are rerecognized pursuant to paragraph 860-20-25-10. If a security is subsequently repurchased, it shall be recorded in accordance with Topic 320.

Because all re-recognized assets are initially recorded at fair value, no loan loss allowance should be initially recognized for loans. Subsequent impairment of the loans should be recognized as a loan loss reserve.
Initial measurement of financial assets upon regaining control

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-20-30-3</td>
</tr>
<tr>
<td>The transferor shall initially measure transferred financial assets and liabilities that are recognized under paragraph 860-20-25-10(a) as a result of regaining control of the financial assets sold at fair value on the date of the change as if the transferor purchased the transferred financial assets and assumed the liabilities on that date.</td>
</tr>
</tbody>
</table>

6.6.1 Removal-of-accounts provision (ROAP)

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-20-25-11</td>
</tr>
<tr>
<td>Whether the removal-of-accounts provision is exercised or not, the transferor shall recognize any financial assets subject to the removal-of-accounts provision if all of the following conditions are met:</td>
</tr>
<tr>
<td>a. A third party’s action (such as default or cancellation) or decision not to act (expiration) occurs.</td>
</tr>
<tr>
<td>b. The occurrence allows removal of assets to be initiated solely by the transferor.</td>
</tr>
<tr>
<td>c. The provision provides a more-than-trivial benefit to the transferor.</td>
</tr>
</tbody>
</table>

For example, once a contingency is met (such as when a given loan goes into default), the call option on that asset (loan) is no longer contingent.

Many transfers of financial assets that involve transfers of a group of entire financial assets to an entity whose sole purpose is to engage in securitization or asset-backed financing activities empower the transferor to reclaim assets subject to certain restrictions (e.g., right to specify the assets to be removed from a credit card master trust). Such a power is commonly referred to as a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor maintaining effective control over transferred financial assets. If it is determined that a ROAP provision allows the transferor to unilaterally cause the return of specific assets, it must also be analyzed to determine whether it provides the transferor with more than a trivial benefit.

One class of contingent rights does not preclude sale accounting because it does not include unilateral rights. The most common type of removal-of-accounts provision is a default ROAP, which gives the holder the right but not the obligation to purchase (call) a loan that is in default (the meaning of default typically is specifically defined in each transaction). Such rights are common in credit card securitizations and in securitizations sponsored by the Government National Mortgage Association (GNMA) and other governmental or quasi-governmental agencies.

---

51 GNMA ROAPs held by the servicer of the transferred loans. However, when the servicer is the transferor, the provisions of ASC 860 apply to the ROAP.
Once the contingency is met (in this case, when a given loan goes into default), the call option on that asset is no longer contingent. At that point, the transfer fails the criterion in ASC 860-10-40-5(c) because the transferor has the unilateral right to purchase a specific transferred financial asset (assuming that right also provides more-than-a-trivial benefit to the transferor\(^{52}\)). Under the requirements of ASC 860-20-25-11, when a contingency related to a transferor’s contingent right has been met, the transferor generally must account for the specific subset of the financial assets transferred to and held by the entity as if it had been repurchased. As noted in ASC 860-20-55-41, the transferor must do so regardless of whether it intends to exercise its call option.

### 6.6.2 Examples that illustrate the requirements of ASC 860-20-25-8 through 25-13 (regaining control)

**Illustration 6-8:** Rerecognition of transferred assets and subsequent accounting for transferor’s interest and a servicing asset

ASC 860-20-55-84 through 55-92 provides the following example that illustrates the accounting for a sale of loans in their entirety by a transferor to an unconsolidated entity and the subsequent accounting for the transferor’s interest and a servicing asset. In this example, the transferor’s interest is an interest-only strip that is accounted for at fair value in the same manner as an available-for-sale security under ASC 860-20-35-2.

On 2 January 20X1, Entity I (the transferor) originates $1,000 of loans, yielding 10.5 percent interest income for their estimated life of 9 years. Entity I later transfers the loans in their entirety to an unconsolidated entity and accounts for the transfer as a sale. Entity I receives as proceeds $1,000 cash plus a beneficial interest that entitles it to receive 1 percent of the contractual interest (an interest-only strip receivable). Entity I will continue to service the loans for a fee of 100 basis points. The guarantor, a third party, receives 50 basis points as a guarantee fee.

At the date of transfer, the following facts are assumed:

a. The fair value of the servicing asset is $40.

b. The total fair value of the loans including servicing is $1,040.

c. The fair value of the interest-income strip receivable is $60.

On 1 December 20X1, an event occurs that results in the transfer not meeting the conditions for sale accounting. The fair value of the originally transferred financial assets that remain outstanding in the entity on that date is $929. The fair value of Entity I’s interest (in the form of an interest-only strip) on that date is $58. The fair value of the servicing asset on that date is $38. The guarantee that was entered into by the entity does not trade with the underlying financial assets. The fees on this guarantee will be paid as part of the cash waterfall.

---

\(^{52}\) GNMA has a standard servicer buyback option feature as part of the securitization program. If a borrower makes no payment for three consecutive months, the servicer (which typically is also the transferor / originator of the underlying loans) has the option to repurchase the loan from GNMA at par. It may be economically advantageous to the servicer to repurchase the delinquent loan out of the pool at par value.

The benefits of a default removal of accounts provision may not always be tangible. For example, a default ROAP may provide a transferor with a “more-than-trivial benefit” by preserving an entity’s reputation in the securitization market. That is, by repurchasing defaulted loans, the transferor preserves the credit quality of beneficial interests held by third-party investors and increases the likelihood that it would be able to utilize the securitization market in the future to meet its funding requirements. Refer to Chapter 5, *Criteria for a sale – Effective control*, for further discussion of rights that provide the transferor a unilateral ability to cause the return of specific transferred financial assets and the concept of “more-than-trivial benefit.”
All cash flows from the financial assets transferred to the trust are initially sent directly to the trust and then distributed in order of priority. The priority of payments in the cash waterfall is as follows: servicing fees, guarantees, amounts due to outside beneficial interest holders, and amounts due to Transferor’s beneficial interest.

The following journal entries would be made.

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 January 20X1</td>
<td>Cash $1,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Transferor’s interest (available-for-sale) $60</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Servicing asset $40</td>
<td>Loans $1,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Gain on sale $100</td>
</tr>
<tr>
<td>Note:</td>
<td>To record the sale of the assets and to recognize Entity I’s interest and a servicing asset at fair value</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 December 20X1</td>
<td>Other comprehensive income $2</td>
<td>Entity I’s interest (available-for-sale) $2</td>
</tr>
<tr>
<td>Note:</td>
<td>To subsequently measure Entity I’s interest in the same manner as an available-for-sale security</td>
<td></td>
</tr>
</tbody>
</table>

The following illustrates the accounting entry to be made after the event occurs that results in the transfer not meeting the conditions for sale accounting.

| Loans $929 | Due to securitization entity $929 |
| Note:      | To recognize the previously sold loans on Entity I’s books along with the obligation to pass the cash flows associated with those loans to Securitization Entity |

Entity I would account for the re-recognized financial assets and transferor’s interests as follows:

a. Entity I would continue to account for transferor’s interests (in accordance with ASC 320-10-35-1) at fair value with changes in fair value recognized in other comprehensive income.

b. Entity I would account for the loans at cost plus accrued interest in accordance with ASC 310-20.

How we see it

Although Entity I has regained control over the loans that were previously sold, Entity I would continue to separately recognize a servicing asset. ASC 860-20-25-10(b) requires that once a servicing asset is recognized it should not be added back to the underlying financial asset. In the FASB’s example, the cash flows from loans will contractually be paid to the unconsolidated entity, which will then distribute the proceeds to satisfy its contractual obligations (including obligations to the beneficial interest holders). Because Entity I, as servicer, is still contractually required to collect the loan’s cash flows for the benefit of the unconsolidated entity and otherwise service the assets, it continues to recognize the servicing asset and assess the asset for impairment if subsequently measured using the amortization method, as required by ASC 860-50-35-9.
The FASB’s illustration may suggest that double counting results when control is regained of previously sold financial assets and the entity continues to hold a beneficial interest in the previously sold assets. The double counting may be inferred from the journal entry in ASC 860-20-55-91, the additional considerations in ASC 860-20-55-92 and the assumptions in ASC 860-20-55-87. Specifically, before the loans are reclaimed or consolidation of the transferee occurs, Entity I recognizes the total fair value of the outstanding loans ($929) while it continues to account for its interest in the loans (i.e., the interest-only strip with a fair value of $38). However, we do not believe double counting was the FASB’s intent. We believe that only the portion of loans subject to a removal-of-accounts provision and attributable to third-party investors should be recognized. In other words, the amount re-recognized by the transferor should be equal to the difference between the total fair value of the loans and the value of the beneficial interest that the transferor continues to recognize on the books. The following example clarifies this concept.

**Illustration 6-9: Rerecognition of transferred assets when a contingent removal-of-accounts provision becomes unconditional**

This example illustrates the accounting by a transferor when a conditional removal-of-accounts provision becomes unconditional, resulting in the transferor regaining control over previously transferred assets that were accounted for as having been sold (as described in ASC 860-20-25 through 25-13).

On 1 January 20X1, Company C (the transferor) transfers to a securitization entity a group of loans that have a par value and an initial fair value of $1,000. Assume that Company C receives cash of $820 from the securitization entity and a beneficial interest with an initial fair value of $180 and retains servicing rights. A third-party obtains subservicing rights that could most significantly affect the economic performance of the securitization entity if the borrowers default on their loans. A different third party holds the senior beneficial interest, entitling it to the first $820 of the loans’ principal collected plus interest (initial fair value of $820). The beneficial interest obtained by Company C as part of the proceeds from the sale (initial fair value of $180) is subordinate to the senior beneficial interest (i.e., the transferor’s subordinated interest bears credit losses first before the senior beneficial interest is affected). Company C also holds a default removal-of-accounts provision (ROAP) with a fixed strike price equal to the individual loan’s par value that gives Company C the right (but not the obligation) to reacquire the loan from the securitization entity if the loan is in default.

Additional assumptions:

- Company C concludes that the transfer qualifies as a sale because each of the derecognition criteria of ASC 860-10-40-5 has been met. The fixed price default ROAP provides Company C with a more-than-trivial benefit but does not preclude sale accounting because it does not provide Company C the unilateral ability to reclaim the transferred loans.

- Company C also concludes that it is not the primary beneficiary of the securitization entity; therefore, consolidation is not required.

- No servicing asset or servicing liability is initially recognized because the contractual benefits of servicing is equal to adequate compensation.

- Company C initially classifies the beneficial interest that it obtains as available-for-sale (AFS) and will subsequently account for it under the guidance in ASC 320.
The following journal entry would be made upon completion of the transfer.

1 January 20X1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 820</td>
</tr>
<tr>
<td>Beneficial interest (AFS)</td>
<td>180</td>
</tr>
<tr>
<td>Loans</td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

**Note:** To record transfer of loans accounted for as a sale

On 31 December 20X1, certain loans held by the securitization entity go into default. At that date, the loans have an aggregate par value of $200 and an estimated fair value of $50. Assume that the loans going into default indicate an OTTI of the beneficial interest held by Company C and that all of the loss is attributed to credit events. Additionally, as a result of the loans defaulting, the removal-of-accounts provision becomes exercisable. The following journal entry would be made.

31 December 20X1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss</td>
<td>$ 150</td>
</tr>
<tr>
<td>Beneficial interest (AFS)</td>
<td>$ 150</td>
</tr>
</tbody>
</table>

**Note:** To recognize in earnings an OTTI on the subordinated beneficial interest in the securitization entity held by Company C because of the default of certain underlying loans

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>$ 20</td>
</tr>
<tr>
<td>Due to securitization entity</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

**Note:** To record loans subject to the default removal-of-accounts provision (ROAP) and obligation to the securitization entity, both recognized at fair value at the time the removal-of-accounts provision is no longer contingent, pursuant to ASC 860-20-25-8 through 25-13. At 31 December 20X1, the fair value amount recorded by Company C represents that portion of the loans attributed to the securitization entity’s obligation to third-party investors and is calculated as follows:

- Total fair value of loans held by the securitization entity as collateral for all beneficial interests issued and outstanding: $850
- Less: securitization entity’s obligations to third-party investors: (820)

- Fair value of loans held by the securitization entity as collateral available to repay Company C’s subordinated beneficial interest: 30

- Total fair value of defaulted loans: 50
- Less: fair value of Company C’s subordinated beneficial interest: 30

- Amount recorded for loans for which control has been regained: $ 20

The difference between the loan amount ($20) recognized by Company C and the estimated fair value of the entire loan ($50) is attributed to the subordinated beneficial interest in the securitization entity that Company C continues to recognize on its balance sheet. Because ASC 860-20-25-10(c) requires Company C to continue to recognize its beneficial interest in the securitization entity (which has an estimated fair value of $30 as of 31 December 20X1), this entry avoids double-counting the fair value attributed to the underlying assets (i.e., the loans).

---

53 Because Company C’s beneficial interest is subordinated, the defaulted loans entirely affect Company C’s beneficial interest (i.e., there is no pro-rata loss sharing).
On 31 January 20X2, the removal-of-accounts provision is exercised by Company C. The following journal entry would be made.

### 31 January 20X2

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>$ 30</td>
</tr>
<tr>
<td>Due to securitization</td>
<td>$ 20</td>
</tr>
<tr>
<td>Beneficial interest</td>
<td>$ 150</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 200</td>
</tr>
</tbody>
</table>

**Note:** To record exercise of the default removal-of-accounts provision and the resulting beneficial interest in the securitization entity to the extent of the additional investment.  

The exercise of the removal of account provision effectively increases the net assets of the securitization entity by $150. After this entry Company C recognizes on its balance sheet the full fair value ($50) of the defaulted (and reclaimed) loans. Company C continues to recognize a subordinated beneficial interest in the securitization entity in the amount of $180.

### Balance sheet comparison

<table>
<thead>
<tr>
<th></th>
<th>Prior to sale</th>
<th>1 January 20X1</th>
<th>31 December 20X1</th>
<th>31 January 20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 300</td>
<td>$ 1,120</td>
<td>$ 1,120</td>
<td>$ 920</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>–</td>
<td>20</td>
<td>50</td>
</tr>
<tr>
<td>Beneficial interest (AFS)</td>
<td>–</td>
<td>180</td>
<td>30</td>
<td>180</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 1,300</td>
<td>$ 1,300</td>
<td>$ 1,170</td>
<td>$ 1,150</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
<td>$ 100</td>
</tr>
<tr>
<td>accrued expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Due to securitization</td>
<td>–</td>
<td>–</td>
<td>20</td>
<td>–</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>100</td>
<td>100</td>
<td>120</td>
<td>100</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive loss</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>200</td>
<td>200</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Total equity</td>
<td>1,200</td>
<td>1,200</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Total liabilities and</td>
<td>$ 1,300</td>
<td>$ 1,300</td>
<td>$ 1,170</td>
<td>$ 1,150</td>
</tr>
<tr>
<td>equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

54. The additional investment would be subject to the periodic evaluation for impairment under applicable guidance.
Questions and interpretive responses

Question 6-1  Classification of transferred debt securities

If a transferee is required to sell the transferred securities and liquidate at a pre-determined time, does the transferor have the option to classify beneficial interests received in the form of debt securities as trading at the time of the transfer?

To illustrate this question, assume the following facts that are based on the FASB’s implementation guidance in ASC 860-10-55-75.

An entity may transfer debt securities to an unconsolidated entity that has a predetermined life in exchange for cash and the right to receive proceeds from the eventual sale of the securities. For example, a third party holds a beneficial interest that is initially worth 25% of the fair value of the assets of the entity at the date of transfer. The entity is required to sell the transferred securities at a predetermined date and liquidate the entity at that time. Assume the facts in that example and the following additional facts:

a. The beneficial interests are issued in the form of debt securities.

b. Before the transfer, the debt securities were accounted for as available-for-sale securities in accordance with ASC 320, Investments—Debt and Equity Securities.

In this example, the initial classification by the transferor would depend on whether the transfer is accounted for as a sale or as a secured borrowing:

a. The transfer would be accounted for as a sale if a transfer of a group of entire financial assets satisfies the conditions to be accounted for as a sale. ASC 860-20 requires that any assets obtained or liabilities incurred in the transfer be recognized (see ASC 860-20-25-1) and initially measured at fair value (see ASC 860-20-30-1). In this case, the transferor would account for the debt securities received as new assets and would have the option to classify the debt securities received as trading securities.

b. If the transfer is accounted for as a secured borrowing, ASC 860-30-25-2 requires the transferor to continue to report the transferred debt securities in its statement of financial position with no change in their measurement (that is, basis of accounting). ASC 320-10-35-12, which explains that transfers into or from the trading category should be rare, would continue to apply.

If the transferred financial assets were not securities subject to the guidance in Topic 320 before the transfer that was accounted for as a sale but the beneficial interests were issued in the form of debt securities or in the form of equity securities that have readily determinable fair values, then the transferor would have the opportunity to decide the appropriate classification of the beneficial interests received as proceeds from the sale.

In the above example, whether the transferor may classify the debt securities as trading at the time of the transfer depends on whether the transfer is accounted for as a sale or as a secured borrowing.

If the transfer is accounted for as a sale, ASC 860-20 requires that any assets obtained or liabilities incurred in the transfer be recognized in accordance with ASC 860-20-25-1 and initially measured at fair value in accordance with ASC 860-20-30-1. The transferor would also account for the debt securities received as new assets and would have the option to classify the debt securities received as trading securities.
If the transfer is accounted for as a secured borrowing ASC 860-30-25-2 requires the transferor to continue to report the transferred debt securities in its statement of financial position with no change in their measurement (that is, basis of accounting). ASC 320-10-35-12 clarifies that transfers into or from the trading category should be rare, would continue to apply.

If the transferred financial assets were not securities subject to the guidance in ASC 320 before the transfer that was accounted for as a sale but the beneficial interests were issued in the form of debt securities or in the form of equity securities that have readily determinable fair values, then the transferor would have the opportunity to decide the appropriate classification of the beneficial interests received as proceeds from the sale.

Question 6-2

Amounts in OCI for AFS securities transferred

In certain transfers that are accounted for as sales, the transferor obtains an interest that should be subsequently accounted for under ASC 325-40, Beneficial Interests in Securitized Financial Assets [Investments-Other]. If the transferred financial asset was accounted for as available-for-sale under ASC 320 prior to the transfer, how should the transferor account for amounts in other comprehensive income at the date of transfer?

ASC 860-20-25-1 requires a transferor to derecognize a transferred financial asset upon completion of a transfer of an entire financial asset that satisfies the conditions to be accounted for as a sale. As a result, the amount in other comprehensive income will be recognized in earnings at the date of transfer.

Question 6-3

Transfer of a bond purchased at a premium

Would an existing premium or discount continue to be amortized or accreted after an entity transfers a bond to an unconsolidated entity for cash and beneficial interests?

The answer depends on whether the transfer is accounted for as a secured borrowing or a sale (i.e., the transfer meets the conditions in ASC 860-10-40-5 for derecognition).

If the transfer of the bond is accounted for as a secured borrowing, the transferor would continue to amortize (or accrete) the premium (or discount) because ASC 860-30-25-2 requires that the transferor continue to report the transferred financial assets in its statement of financial position with no change in their measurement (that is, basis of accounting).

If the transfer of the bond satisfies the conditions to be accounted for as a sale, any beneficial interests received as proceeds would be initially recognized at fair value. As a result, the previously existing premium (or discount) would not continue to be amortized (or accreted); rather, the unamortized (or nonaccreted) amount would be included in the calculation of the gain (or loss) as of the transfer date.

Question 6-4

Transfers of receivables with recourse

Can the method used by the transferor for providing “recourse” affect the accounting for a transfer to an unconsolidated entity?

The effect of a recourse provision on the application of ASC 860-10-40-5 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred financial assets beyond the reach of the transferor, its consolidated affiliates and its creditors, but transfers with limited recourse may.

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55 Reproduced from question 62 of the FASB Staff’s Special Report, Questions and Answers Related to Implementation of FASB Statement No. 140, as amended by Statement 166. This question and answer was not codified.
Transfer consists of an entire financial asset or a group of entire financial assets

Before the method of recourse can be evaluated to determine the appropriate accounting treatment, the entity shall first determine whether a sale has occurred because in some jurisdictions recourse might mean that the transferred financial assets have not been isolated beyond the reach of the transferor, its consolidated affiliates (that are not entities designed to make remote the possibility that it would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors. A transfer of receivables in their entireties with recourse should be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the conditions in ASC 860-10-40-5 are met. Otherwise, a transfer of receivables with recourse should be accounted for as a secured borrowing.

Transfer does not consist of an entire financial asset or a group of entire financial assets

The transferred financial asset must meet the definition of a participating interest. A transfer of a portion of a receivable with recourse, other than that permitted in ASC 860-10-40-6A(c)(4), does not meet the requirements of a participating interest and should be accounted for as a secured borrowing.

Question 6-5 Distinguishing new interests obtained from part of a beneficial interest obtained

What should the transferor consider when determining whether credit risk is a separate liability or part of a beneficial interest that has been obtained by the transferor?

In determining whether credit risk is a separate liability or part of a beneficial interest that has been obtained by the transferor, ASC 860-20-25-6 clarifies that the transferor should focus on the source of cash flows in the event of a claim by the transferee. If the transferee can only look to cash flows from the underlying financial assets, the transferor has obtained a portion of the credit risk only through the interest it obtained and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the interest that the transferor obtained.

In contrast, if the transferor could be obligated for more than the cash flows provided by the interest it obtained and, therefore, could be required to reimburse the transferee for credit-related losses on the underlying assets, the transferor should record a separate liability. It is not appropriate for the transferor to defer any portion of a resulting gain or loss (or to eliminate gain on sale accounting, as it is sometimes described in practice).

Question 6-6 Credit enhancements

How should a transferor initially and subsequently measure credit enhancements (e.g., cash reserve accounts) provided in a transfer of an entire financial asset or a group of entire financial assets to an unconsolidated entity that is accounted for as a sale if the balance that is not needed to make up for credit losses is ultimately to be paid to the transferor?

ASC 860-20-30-1 clarifies that the transferor should initially measure any asset obtained (or liability incurred) and recognized under ASC 860-20-25-1 at fair value. While ASC 860 does not specifically address the subsequent measurement of credit enhancements there are some factors to consider. Factors such as how much cash the transferor will receive from, for example, a cash reserve account, and when it will receive cash inflows depend on the performance of the transferred financial assets. Entities should regularly review those assets for impairment because of their nature. Entities should look to other guidance for subsequent measurement including guidance for impairment based on the nature of the credit enhancement.
Question 6-7  Estimating the fair value of beneficial interests with “turbo” or “bullet” provisions

What effects do “turbo” and “bullet” provisions in securitization structures have on the accounting for the transfers of financial assets?

Many securitization structures provide for a disproportionate distribution of cash flows to various classes of investors during the amortization period, which is referred to as a “turbo” provision. For example, a turbo provision might require the first $100 million of cash received during the amortization period of the securitization structure to be paid to one class of investors before any cash is available for repayment to other investors. Similarly, certain revolving-period securitizations use what is referred to as a “bullet” provision as a method of distributing cash to their investors. Under a bullet provision, during a specified period preceding liquidating distributions to investors, cash proceeds from the underlying assets are reinvested in short-term investments other than the underlying revolving-period receivables. Those investments mature or are otherwise liquidated to make a single bullet payment to certain classes of investors.

ASC 860-20-55-16 clarifies that trust liquidation methods that allocate receipts of principal or interest between beneficial interest holders and transferors in proportions different from their stated percentage of ownership interests do not affect whether the transferor should obtain sale accounting and derecognize those transferred assets, assuming the trust is not required to be consolidated by the transferor. However, both turbo and bullet provisions in securitization structures should be taken into consideration in determining the fair values of assets obtained by the transferor and transferee.

Question 6-8  Accrued interest receivable

How should an entity account for the accrued interest receivable related to securitized and sold credit card receivables?

The receivables for accrued fee and finance charge income on an investor’s portion of the transferred credit card receivables, whether billed but uncollected or accrued but unbilled, are commonly referred to as accrued interest receivable.

ASC 860-20-55-18 clarifies that generally, if a securitization transaction meets the criteria for sale treatment and the accrued interest receivable is subordinated either because the asset has been isolated from the transferor or because of the operation of the cash flow distribution (or “waterfall”) through the securitization trust, the total accrued interest receivable should be considered to be one of the components of the sale transaction. Therefore, under the circumstances described, the accrued interest receivable asset should be accounted for as a transferor’s. It is inappropriate to report the accrued interest receivable related to securitized and sold receivables as “loans receivable.” Terminology implying that the accrued interest receivable has not been subordinated to the senior interests in the securitization should not be used.

ASC 860-20-55-19 also clarifies that in such circumstance, the accrued interest receivable is a transferor’s interest, and it is not required to be subsequently measured like an investment in debt securities classified as available for sale or trading under ASC 320 because the accrued interest receivable cannot be contractually prepaid or settled in such a way that the owner would not recover substantially all of its recorded investment. In such cases, entities should follow existing applicable accounting standards, including ASC 450 for subsequently accounting for the accrued interest receivable.

The same conclusion applies to other types of securitization transactions.
Question 6-9 Options embedded in transferred securities

Assume a transaction involves the sale of a marketable security to a third-party buyer, with the buyer having an option to put the security back to the seller at a specified future date or dates for a fixed price. Because of the put option, the seller generally receives a premium price for the security. Should an entity account for the put option as a derivative or a guarantee?

ASC 860-20-55-21 through 55-23 clarifies that if the transfer is accounted for as a sale, a put option that enables the holder to require the writer of the option to reacquire for cash or other assets a marketable security or an equity instrument issued by a third party should be accounted for as a derivative by both the holder and the writer, provided the put option meets the definition of a derivative in ASC 815-10-15-83 (including meeting the net settlement requirement, which may be met if the option can be net settled in cash or other assets or if the asset required to be delivered is readily convertible to cash). If multiple put options exist, recognition of the multiple put options as liabilities, and initial measurement at fair value, are required.

A put option that is issued as part of a transfer being accounted for as a sale that is not accounted for as a derivative under ASC 815-10 would be considered a guarantee under ASC 460-10-55-2(b) and would be subject to its initial recognition, measurement, and disclosure requirements. If the written put option is accounted for as a derivative under ASC 815-10 by the seller-transferor, then the put option would be subject to only the disclosure requirements of ASC 460.

If the transaction is accounted for as a secured borrowing under ASC 860-30, any difference between the sale proceeds and the put price should be accrued as interest expense, and any impairment of the underlying security would generally not be recognized. The difference between the original sale price and the put price should be amortized over the period to the first date the securities are eligible to be put back. If the transfer is accounted for as a secured borrowing, the put option falls under ASC 815-10-15-63, which provides a scope exception for a derivative instrument (such as the put option) that serves as an impediment to sale accounting under ASC 860-10.
7 Servicing of financial assets

7.1 Introduction

A servicing right is a contract to perform specific administration functions for an asset or groups of assets. Determining when to recognize a servicing asset or servicing liability (collectively referred to as servicing rights) depends on how the servicing contract was obtained. Servicing rights are initially measured at fair value and subsequently measured at fair value or under an amortization methodology (subject to impairment). This chapter provides an overview of servicing rights and discusses ASC 860’s guidance regarding the initial recognition and measurement, subsequent measurement, as well as derecognition of servicing rights.

7.2 Overview of servicing rights and responsibilities

Excerpt from Accounting Standards Codification

860-50-05

05-2 Servicing is inherent in all financial assets; it becomes a distinct asset or liability for accounting purposes only in the circumstances described in paragraph 860-50-25-1.

05-3 Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, the following activities:

a. Collecting principal, interest, and escrow payments from borrowers
b. Paying taxes and insurance from escrowed funds
c. Monitoring delinquencies
d. Executing foreclosure if necessary
e. Temporarily investing funds pending distribution
f. Remitting fees to guarantors, trustees, and others providing services
g. Accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets.

05-4 A servicer of financial assets commonly receives the following benefits of servicing:

a. Revenues from contractually specified servicing fees
b. A portion of the interest from the financial assets
c. Late charges
d. Other ancillary sources, including float.

A servicer is entitled to receive all of those benefits of servicing only if it performs the servicing and incurs the costs of servicing the financial assets.

The pooling and servicing agreement specifies the servicer’s responsibilities including how to allocate and distribute cash flows to beneficial or participating interest holders. It also describes how the assets are to be serviced and the requirements for special circumstances.
The complexity of servicing activities can vary based on the type of asset being serviced. For example, servicing conventional mortgage loans is less complex than subprime mortgage loans, which have a higher probability of default and may require some form of remediation (e.g., loan modification or foreclosure). The servicer’s relative strengths and capabilities is one of the factors considered by rating agencies because servicing adds an element of operational risk to the transaction, failure of which can have a negative effect on the ultimate cash flows of a securitization transaction.

Structures may require the use of multiple servicers, including master servicers, primary or sub-servicers or special servicers. In general, a master servicer is primarily responsible for the servicing activities of the trust or securitization vehicle. The master servicer collects payments, redistributes those cash collections and performs other administrative and record keeping responsibilities.

Often, a primary or sub-servicer is an affiliate of the asset originator who maintains direct contact with the borrower. Due to this relationship, the master servicer often sub-contracts certain responsibilities (e.g., monthly cash remittance handling) to the primary servicer, and the parties enter into a subservicing agreement. This agreement typically mirrors the provisions under the servicing agreement (i.e., the agreement between the master servicer and the trust), thereby limiting the primary servicer’s discretion and subjecting it to the same servicing standard as the master servicer.

A special servicer typically manages distressed or defaulted assets or other specified events (e.g., legal settlements). Special servicers generally specialize in certain types of distressed financial assets (e.g., commercial properties, residential real estate), many of which require a unique level of expertise.

While all servicers are generally responsible to mitigate the risk of default, a special servicer may specifically manage a default or foreclosure process, considering various options to maximize the recovery from the borrower (e.g., loan modifications, deed in lieu, negotiated payoff, foreclosure).

The compensation received for servicing generally is commensurate with the required level of involvement and, therefore, is typically different for the master servicer, primary or sub-servicer and the special servicer.

### 7.3 Initial recognition and measurement requirements

#### 7.3.1 Initial recognition

**Excerpt from Accounting Standards Codification**

860-50-25

25-1 An entity shall recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:

a. A servicer’s transfer of any of the following, if that transfer meets the requirements for sale accounting:
   1. An entire financial asset
   2. A group of entire financial assets
   3. A participating interest in an entire financial asset, in which circumstance the transferor shall recognize a servicing asset or a servicing liability only related to the participating interest sold.

b. [Subparagraph superseded by Accounting Standards Update 2009-16]

c. An acquisition or assumption of a servicing obligation that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements being presented.

25-3 A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those financial assets.
While servicing is inherent in all financial assets, servicing assets and servicing liabilities are not themselves financial instruments; rather, they represent executory contracts. Separate recognition is required under ASC 860-50-25-1 and 25-3 when the servicing asset or servicing liability is contractually separated from the underlying financial assets and the underlying financial assets are excluded from the servicer’s and its consolidated affiliates’ financial statements.

7.3.1.1 Exception to the separate recognition of a servicing right principle

ASC 860-50-25-4 provides an exception to the general principle regarding when a servicing right should be recognized and states that in a transfer that qualifies as a sale in which the transferor obtains the resulting securities and classifies them as debt securities held to maturity in accordance with ASC 320, the servicing asset/liability may be either separately recognized or reported together with the asset being serviced. We believe that this exception may be applied only if the transferor takes back all of the resulting securities.

7.3.1.2 Transactions that prohibit the separate recognition of a servicing asset or servicing liability

Under ASC 860-50-25-2, no servicing asset or servicing liability should be recognized when a servicer transfers financial assets in a transaction that does not meet the requirements for sale accounting (i.e., the transfer is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor’s balance sheet).

7.3.2 Initial measurement

Excerpt from Accounting Standards Codification

860-50-30

30-1 An entity shall initially measure at fair value, a servicing asset or servicing liability that qualifies for separate recognition regardless of whether explicit consideration was exchanged.

30-2 Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. Paragraph 860-50-35-1A states that a servicing asset may become a servicing liability, or vice versa, if circumstances change. The initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities. A servicing contract that entitles the servicer to receive benefits of servicing just equal to adequate compensation, regardless of the servicer’s own servicing costs, does not result in recognizing a servicing asset or a servicing liability. A purchaser would neither pay nor receive payment to obtain the right to service for a rate just equal to adequate compensation.

30-3 The determination of whether the servicer is adequately compensated for servicing specified assets is based on the amount demanded by the marketplace, not the contractual amount to be paid to a replacement servicer. However, that contractual provision would be relevant for determining the amount of contractually specified servicing fees. Therefore, the amount that would be paid to a replacement servicer under the terms of the servicing contract can be more or less than adequate compensation.

30-4 Whether a servicing asset or servicing liability is recorded is a function of the marketplace, not the servicer’s cost of servicing. For example, a loss shall not be recognized if a servicing fee that is equal to or greater than adequate compensation is to be received but the servicer’s anticipated cost of servicing would exceed the fee.

In determining fair value, a servicer should evaluate whether the benefits of servicing obtained from the contract are greater or less than adequate compensation for performing the servicing. The benefits of servicing include the revenues from contractually specified servicing fees (e.g., a portion of the interest
from the financial assets being serviced), late charges, and other ancillary sources of income to be received for performing servicing. Such other sources of income include rights to short-term investment proceeds earned from investing excess cash payments prior to their required distribution to investors or third-party beneficial interest holders – commonly known as “float.”

**Excerpt from Accounting Standards Codification**

**Adequate Compensation**

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

If the benefits of servicing are greater than adequate compensation, the servicer should recognize a servicing asset and a servicing liability when the benefits are less than adequate compensation, even if no explicit consideration is exchanged for the servicing contract. If the benefits of servicing are equal to adequate compensation, no servicing asset or liability is recognized.

The determination of adequate compensation is a market notion and should be made independent of the entity’s cost structure. A servicing asset or servicing liability is based upon the fair value of servicing, which is the amount that a servicer would pay to acquire (or transfer) in the market the rights to service. As a result, an inefficient servicer may recognize a servicing asset, even if its actual costs to service are higher than its level of compensation. Likewise, an efficient servicer may recognize a servicing liability, even if it can profitably perform the servicing below the contractually specified fee or adequate compensation, as defined.

The basis for determining adequate compensation should be well documented, and entities should ensure that their calculations of estimated fair value for their servicing assets and liabilities consider only the difference between the benefits of servicing and adequate compensation as determined by the marketplace. Considerations for estimating the value of servicing rights are discussed further in section 7.4.

**7.3.3 Illustrations of initial recognition and measurement of servicing rights**

To illustrate the initial recognition and measurement requirements for servicing contracts, consider the following examples.

**Illustration 7-1: Initial recognition and measurement of a servicing asset**

**Assumptions:** A servicer receives a 50 basis point fee for servicing transferred financial assets (which qualified for sale accounting) in accordance with the pooling and servicing agreement. The servicer has an internal servicing cost of 35 basis points. The market expectation to service this type financial asset is 30 basis points for the cost and 6 basis points of profit. (Note: For simplicity, in this example, the fair value of income from float and other ancillary income is considered to be nominal.)

**Computation:** The servicing asset would be calculated based on an excess of 14 basis points over adequate compensation. This amount represents the 50 basis point contractual servicing fee, less the sum of (a) the market expectation of the cost of servicing of 30 basis points and (b) the market expectation of profit for servicing this particular type of financial asset of 6 basis points. The servicer’s internal servicing cost is irrelevant to determining the existence of a servicing asset or liability.
Illustration 7-1(a): Initial recognition and measurement of a servicing liability

Assumption: Same as Illustration 7-1 above, except the market expectation of the cost of servicing is 40 basis points and the market expectation of profit for servicing is 12 basis points.

Computation: A servicing liability based on 2 basis points under adequate compensation would be recognized, even though the transferor’s internal cost of servicing is only 30 basis points. This amount represents the 50 basis point contractual servicing fee, less the sum of (a) the market expectation of the cost of servicing of 40 basis points and (b) the market expectation of profit for servicing this particular type of financial asset of 12 basis points.

Illustration 7-1(b): Servicing contracts that result in the initial recognition of an asset, even if considered burdensome to the servicer

Assumption: Same as Illustration 7-1 above, except the internal cost of servicing is higher than the contractual servicing fees, but the market expectation for the cost of servicing and profit are lower.

Computation: While the transferor would experience negative cash flows under the servicing agreement, it still would recognize a servicing asset. Fair value represents what the market would pay or charge to assume servicing. As such, any difference between the servicer’s internal costs and the costs assumed by the marketplace are not considered in the fair value of the asset or liability but instead recognized over time as the financial assets are serviced, whether they represent relative efficiencies or inefficiencies. That is, the actual costs of servicing and the fees earned including changes in the fair value (or amortized cost) of the servicing asset or liability are recognized as they occur through the income statement.

7.3.4 Distinguishing servicing from an interest-only strip

Excerpt from Accounting Standards Codification

860-50-25

25-6 A servicer shall account separately for rights to future interest income from the serviced assets that exceed contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 860-20-35-2.

25-7 Whether a right to future interest income from serviced assets should be accounted for as an interest-only strip, a servicing asset, or a combination thereof, depends on whether a servicer would continue to receive that amount (that is, the value of the right to future interest income) if a substitute servicer began servicing the assets. Therefore, any portion of the right to future interest income from the serviced assets that would continue to be received even if the servicing were shifted to another servicer would be reported separately as a financial asset in accordance with paragraph 860-20-35-2. For guidance on why an interest-only strip precludes a portion of a financial asset from meeting the definition of a participating interest, see paragraph 860-10-55-17K.

25-8 The value of the right to receive future cash flows from ancillary sources such as late fees shall be included in the measurement of the servicing asset, not the interest-only strip, if retention of the right to receive the cash flows from those fees depends on servicing being performed satisfactorily, as is generally the case.
In all cases, an entity should differentiate the contractual benefits of servicing (i.e., the amounts that will be received specifically for servicing activities) from other forms of consideration retained after the transfer. In other words, any rights to future income from the transferred financial asset that are not dependent on the transferor performing servicing activities are beneficial interests. In many cases, they will represent interest-only strips that are recognized and measured in accordance with ASC 815, Derivatives and Hedging, or ASC 320-10, Investments – Debt and Equity Securities – Overall. Interest-only strips obtained in securitizations, which do not depend on servicing, may be subsequently measured differently from the related contractual servicing rights. For example, the transferor may elect to subsequently measure a servicing right under the amortization method while the related interest-only strip will be remeasured at fair value.

7.3.5 “Normal” versus “excess” servicing and their effect on transfers of portions of financial assets

Any portion of a servicing benefit that is significantly higher than adequate compensation is referred to as “excess” servicing and could affect the accounting for transfers involving portions of an entire financial asset.

For transfers involving an entire financial asset or groups of entire financial assets, the existence of an excess servicing benefit does not alter the initial or subsequent measurement requirements of the contractual servicing asset because the “excessive” portion of a servicing right, which comes from a single contract, generally cannot be separately sold after the sale or securitization of the underlying financial assets. The excess servicing portion, like normal servicing, will be collected only if the servicing work is performed satisfactorily. While excess servicing economically resembles an interest-only strip in some respects, the FASB concluded that accounting based on that distinction is unduly complex and would often result in several assets and liabilities being recognized for one servicing contract.

An excess servicing right in a transfer of a portion of an entire financial asset would preclude sale accounting because that portion would not meet the definition of a participating interest. Instead, that excess servicing right is economically similar to an interest-only strip. Because the cash flows are not allocated proportionately when there is an interest-only strip, the transferred portion would not be considered a participating interest.

However, ASC 860-10-40-6A states that servicing fees are excluded from the cash flows required to be allocated proportionately to participating interest holders provided payment for such services are both (a) not subordinate to the proportionate cash flows of participating interest and (b) not significantly above adequate compensation.

This concept is further discussed in the following codification excerpt.

Excerpt from Accounting Standards Codification

860-10-55-17K

The transfer of a portion of an entire financial asset may result in a gain or loss on the transfer if the contractual interest rate on the entire financial asset differs from the market rate at the time of transfer. Paragraph 860-10-40-6A(b)(2) precludes a portion from meeting the definition of a participating interest if the transfer results in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows. For example, if the transferor transfers an interest in an entire financial asset and the transferee agrees to incorporate the excess interest (between the contractual interest rate on the entire financial asset and the market interest rate at the date of transfer) into the contractually specified servicing fee, the excess interest would likely result in the conveyance of an interest-only strip to the transferor from the transferee. An interest-only strip would result in a disproportionate division of cash flows of the financial asset among the participating interest holders and would preclude the portion from meeting the definition of a participating interest.

See questions 7-1 to 7-5 for additional interpretive guidance.
7.4  

Fair value considerations

7.4.1  

Observable and non-observable inputs and assumptions

When determining the fair value of a servicing contract, the servicer must consider all relevant valuation assumptions and inputs. Quoted prices in active markets are the best evidence of fair value and they should be used as the basis of measurement, if available. However, quoted market prices typically are not available for servicing contracts. In these instances, use of a valuation technique, such as a discounted cash flow model or an option-pricing model (which incorporates present value techniques), will be required in estimating the fair value. To the extent possible, observable inputs should be used in the valuation model. However, certain inputs, such as prepayment risk and industry or third-party costs to service, may be unobservable and therefore need to be estimated.

The valuation of a servicing contract should consider the estimated timing and amount of contractual benefits the servicer will receive during the life of the servicing arrangement. This valuation should also consider the market expectation of the cost of servicing and the market expectation of profit for servicing the particular type of financial asset, all discounted at an appropriate rate. Essentially, the fair value of a servicing contract represents the period over which market participants expect to earn a return which is in excess of or below adequate compensation. Because the timing and amount of future cash flows are in most cases uncertain, the fair value measurement should include a risk premium reflecting the amount market participants would demand as compensation for bearing the uncertainty in the cash flows. This risk premium could be included in either the expected cash flows directly or captured through the use of a risk-adjusted discount rate.

Any valuation technique should incorporate market participant expectations about future cash flows and costs associated with servicing the financial assets, including the required profit margin. For example, it would not be appropriate for a servicer to estimate the fair value of a servicing asset based on the present value of the projected difference between the contractual servicing cash flows and the servicer’s own costs plus a market-based profit margin over the life of the financial assets being serviced. However, that approach would be acceptable if the servicer also supports that its cost assumption is consistent with the cost assumption that would be used by other market participants. Servicers may want to consider obtaining a third-party valuation of their servicing assets and liabilities to support their fair value measurements, particularly when limited market participant data is available. The valuation technique used to estimate the fair value of servicing rights would also incorporate market participant assumptions about interest rates, default rates and prepayment speeds, among other considerations. Estimates of the expected cash inflows that will be received by the servicer may also be affected by other provisions such as ancillary fees (ancillary fees are discussed below).

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56 Refer to our Financial Reporting Developments publication on ASC 820, Fair value measurement, for further discussion on the valuation techniques utilized for fair value measurement purposes.
The following table identifies and discusses specific examples of common valuation inputs used in estimating the fair value of a servicing contract:

<table>
<thead>
<tr>
<th>Input considerations</th>
<th>Potential effect on fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Servicing fee</strong></td>
<td>All contractual amounts that are due to the servicer in exchange for servicing the financial asset that would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer.</td>
</tr>
<tr>
<td><strong>Prepayment speed</strong></td>
<td>Prepayment speed represents the rate at which underlying asset prepayments are expected to occur. Estimating prepayment speed is highly subjective and requires consideration of various factors, including geographical characteristics, average loan balances, credit quality of the portfolio, and interest rates (i.e., fixed or floating), among other considerations. Changes in estimated prepayment speeds have a direct and inverse effect on the fair value of servicing contracts. That is, an increase in expected prepayment speed (that might result from an expected decrease in interest rates) decreases the future cash flows and fair value, while a decrease in expected prepayment speed (that might result from an expected increase in interest rates) would increase the future cash flows and fair value of the servicing asset.</td>
</tr>
<tr>
<td><strong>Discount rates</strong></td>
<td>Discount rates are used for discounting future cash inflows and outflows associated with the servicing contract. Assuming that the cash flows capture the effect of uncertainty associated with prepayment speeds, interest rates and other elements of risk, the discount rates are generally comprised of two components – a risk-free rate and a risk premium. The risk-free rate varies with changes in interest rates irrespective of changes in risks associated with the underlying assets or service contract. The risk premium contemplates the underlying risks of a servicing contract. For example, a greater expected variability of prepayment speeds would result in a market participant demanding a higher risk premium as compensation for the increased uncertainty regarding the period of time over which they will earn compensation. Conversely, lower expected variability of prepayment speeds would result in a market participant demanding a lower risk premium. Other factors that affect the risk premium include, but are not limited to, the nature and uncertainties associated with the underlying assets, geography and availability of recourse.</td>
</tr>
<tr>
<td>Input considerations</td>
<td>Potential effect on fair value</td>
</tr>
<tr>
<td>------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Cost of servicing</td>
<td>While not entity specific, a market participant’s expected cost to service the underlying financial assets is a factor in determining the fair value of a servicing contract. If market participants view the operational costs of servicing (e.g., postage, labor, data management, computing costs) have risen or fallen such expectations would be included in the determination of fair value. The type of financial assets serviced is an important consideration when estimating fair value. The types of assets being serviced affect the amount required to adequately compensate the servicer. For example, the amount of effort required to service a home equity loan likely would be different from the amount of effort required to service a credit card receivable or a small business administration loan.</td>
</tr>
<tr>
<td>Delinquency and default rates</td>
<td>Default rate assumption represents the rate at which underlying financial assets are expected to default. Assumptions regarding default rate should reflect a market participant expectation of defaults associated with a given type of financial asset.</td>
</tr>
<tr>
<td>Float income</td>
<td>The rights to short-term investment proceeds earned from investing excess cash payments prior to their required distribution to investors or third-party beneficial interest holders. The benefit of the float accrues to the servicer through interest earned or a reduction of its cost of funds. The value of a right to potential future cash flows derived from the float should be factored into the estimated fair value of a servicing contract because such benefits directly affect the fair value of the servicing rights. However, like all other inputs and assumptions, such factors should be based on a market participant’s expectations.</td>
</tr>
<tr>
<td>Ancillary income</td>
<td>Examples of items that generate ancillary income for servicers include earnings resulting from temporarily investing cash received from underlying loan holders (e.g., principal and interest payments) before the cash is paid to the eventual recipients (e.g., beneficial interest holders), late fee income, telephone payment fees and returned check fees. Therefore, the expected amount of these cash flows directly impacts the fair value of the servicing contract. We also believe a servicer’s fair value measurement should consider whether the servicing contract is transferable and any cancellation and expiration provisions, including whether the contract may be cancelled at will or expires prior to the maturity or expected prepayment date of the underlying portfolio of assets. These types of contractual provisions may significantly affect the fair value of a servicing contract. Differences in fair value may result between servicing assets and liabilities related to servicing contracts obtained through the transfer of financial assets and those entered into on an “executor” basis, because the latter are not more likely to be transferable and to include cancellation and expiration provisions.</td>
</tr>
</tbody>
</table>
7.4.2 Consistent use of fair value measurement techniques

Valuation techniques should be consistently applied from period to period. However, if a change in the valuation technique (or a change in the relative importance of one technique versus another) results in a more representative fair value measurement estimate, such changes should be implemented, and the effect of such a change should be disclosed as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*. When multiple valuation techniques are used, the merits of each valuation technique and the underlying assumptions embedded in each of the techniques should be considered in evaluating and assessing the results.

Servicers often use cash flow models to estimate the fair value of servicing assets and liabilities because quoted market prices, or observable market inputs for the valuation model, may not be available. While this is common practice, it is important to consider whether the approach and assumptions used in such models and valuation techniques are appropriate and consistent with those that a market participant would use.

Some servicers may consider obtaining the assistance of a third-party valuation specialist to estimate the fair value of its servicing rights. The use of a third-party valuation specialist does not reduce management’s ultimate responsibility for the fair value measurements (and related disclosures) in the entity’s financial statements. Management must understand the assumptions used in the valuations, including those performed in accordance with the USPAP57, and determine whether the assumptions are consistent with ASC 820, *Fair Value Measurement*. That is, management may determine that an adjustment to the third-party specialist’s valuation may be necessary to comply with the provisions of ASC 820. Entities must also ensure that the appraisal process and report are consistent with the requirements of ASC 820. This may require consideration of, but is not limited to, each of the following:

- Whether the principal or most advantageous market has been appropriately considered
- Whether appropriate market participants (or characteristics of market participants) have been identified
- Whether the assumptions market participants would utilize in pricing the asset have been used
- Whether adjustments to market data are based on observable or unobservable inputs and whether such adjustments are significant to the overall fair value measure
- Whether appropriate valuation approaches and techniques have been utilized

In the absence of an independent third-party appraisal, an entity may corroborate the reasonableness of its servicing assets’ and servicing liabilities’ fair value estimates and related processes, by periodically performing each of the following:

- Analyzing and comparing its own fair value estimates, including model inputs (e.g., discount rates, default rates, prepayment speeds, servicing costs), to market data which may be available through external surveys, broker quotes or trading/acquisition activity in the marketplace
- Reconciling actual monthly cash flows to the cash flow projections made by the valuation model to validate and calibrate the model

Refer to our Financial Reporting Developments publication on ASC 820, *Fair value measurement*, for further discussion.

See question 7-6 for additional interpretive guidance.

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57 The Uniform Standards of Professional Appraisal Practice (USPAP) are the generally accepted standards for professional appraisal practice in North America in valuing real estate, personal property and businesses. An assessment of the appraisal should be performed to determine that the appraised value is an appropriate measure of fair value for financial reporting purposes (i.e., the appraisal has been performed in accordance with the principles of ASC 820).
Subsequent measurement election

**Excerpt from Accounting Standards Codification**

**860-50-35**

35-1 An entity shall subsequently measure each class of servicing assets and servicing liabilities using either of the following methods:

a. Amortization method. Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues), and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

b. Fair value measurement method. Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value of servicing assets and servicing liabilities in earnings in the period in which the changes occur.

35-2 The election described in paragraph 860-50-35-1 through 35-5 shall be made separately for each class of servicing assets and servicing liabilities.

**Implementation guidance**

35-3 The following guidance applies to the election of a method for subsequent measurement of servicing assets and servicing liabilities:

a. Once an entity elects the fair value measurement method for a class of servicing assets and servicing liabilities, that election shall not be reversed.

b. Different elections can be made for different classes of servicing assets and servicing liabilities.

c. Once a servicing asset or a servicing liability is reported in a class of servicing assets and servicing liabilities that an entity elects to subsequently measure at fair value, that servicing asset or servicing liability shall not be placed in a class of servicing assets and servicing liabilities that is subsequently measured using the amortization method.

d. An entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year.

e. Transferring servicing assets and servicing liabilities from a class subsequently measured using the amortization method to a class subsequently measured at fair value is permitted as of the beginning of any fiscal year. If an entity makes such a transfer, subsequent measurement of servicing assets and servicing liabilities at fair value shall be applied prospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year to reflect the difference between the fair value and the carrying amount, net of any related valuation allowance, of the servicing assets and servicing liabilities that exist at the beginning of the fiscal year in which the entity makes the fair value election.

f. If an entity recognizes a new class of servicing assets and servicing liabilities, and no servicing assets and servicing liabilities that would belong to this class had previously been recognized by the entity, the entity may elect to subsequently measure that new class of servicing assets and servicing liabilities at fair value at the date of initial recognition of those servicing assets and servicing liabilities.

35-4 An entity shall apply the same subsequent measurement method to each servicing asset and servicing liability in a class.
Identifying classes of servicing assets and servicing liabilities

Excerpt from Accounting Standards Codification

860-50-35
35-5 Classes of servicing assets and servicing liabilities shall be identified based on any of the following:

a. The availability of market inputs used in determining the fair value of servicing assets or servicing liabilities

b. An entity’s method for managing the risks or its servicing assets or servicing liabilities.

35-6 Under the approach in the preceding paragraph, a servicer may or may not consider the major asset type of the underlying financial asset being serviced when identifying its classes of separately recognized servicing assets and servicing liabilities. Further, this approach for defining classes of servicing assets and servicing liabilities is not analogous to the stratification guidance for determining impairment of servicing assets or servicing liabilities that are subsequently measured using the amortization method.

7.5.1 Fair value measurement method

Under the fair value subsequent measurement method, classes of servicing assets or servicing liabilities are measured at fair value each reporting date with changes in fair value recognized in earnings. The fair value measurement method simplifies the accounting because the fair value of derivatives used to economically hedge the servicing assets and servicing liabilities can be currently recognized in earnings without having to apply hedge accounting.

At the beginning of any fiscal year, an entity may make an irrevocable decision to subsequently measure a specific class of servicing assets or servicing liabilities at fair value with changes in fair value reported in earnings. That decision does not affect the subsequent accounting measurement decisions of other classes of servicing assets and servicing liabilities. That is, the fair value election may be made on a class-by-class basis. If an entity elects to subsequently measure a class at fair value, that subsequent measurement policy may not change. That is, a servicer may elect to change from the amortization method to the fair value method, but it may not change from the fair value method to the amortization method.

For example, an entity may have identified two different classes of recognized servicing assets and servicing liabilities (Class A and Class B) for which it previously applied the amortization policy for subsequent measurement. On the first day of its fiscal year, the entity can elect to subsequently measure Class A at fair value. Class B can continue to be measured using the amortization method. The fair value election for Class A is now irrevocable. The entity can still change its subsequent measurement policy for Class B to fair value as of the first day of any subsequent fiscal year. However, if and when that election is made, it would also be irrevocable.

7.5.2 Amortization method

Under the amortization method, classes of servicing assets or servicing liabilities are amortized through earnings in proportion to, and over the period of, estimated net servicing income for servicing assets or the period of estimated net servicing loss for servicing liabilities. In addition, under this method, each class of servicing assets or servicing liabilities is evaluated for impairment or increased obligation based on fair value at each reporting date.
Impairment analysis

Excerpt from Accounting Standards Codification

860-50-35

35-7 An entity shall first identify its classes of separately recognized servicing assets and servicing liabilities under the approach in paragraph 860-50-35-5. For any class subsequently measured using the amortization method, an entity shall then stratify that class to determine if impairment has occurred, as discussed in paragraph 860-50-35-9(a).

35-9 An entity shall evaluate and measure impairment of each class of separately recognized servicing assets that are subsequently measured using the amortization method described in paragraph 860-50-35-1(a) as follows:

a. Stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location. For mortgage loans, financial asset type refers to the various conventional or government guaranteed or insured mortgage loans and adjustable-rate or fixed-rate mortgage loans.

b. Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized separately shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.

c. Adjust the valuation allowance to reflect changes in the measurement of impairment after the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized.

35-10 This Subtopic does not address when an entity should record a direct write-down of recognized servicing assets.

35-11 For servicing liabilities subsequently measured using the amortization method, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows relative to the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings. That is, if subsequent events increase the fair value of a stratum of servicing liabilities within a class that an entity has elected to subsequently measure using the amortization method, that increase shall be recognized in earnings as a loss. Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation shall not be reduced below the amortized measurement of the initially recognized servicing liability.

35-12 The impairment provisions of paragraphs 860-50-35-9 and 860-50-35-11 for classes of servicing assets and servicing liabilities subsequently measured using the amortization method are based on the fair value of the contract rather than the gain or loss from subsequently carrying out the terms of the contract.

35-13 An entity is not required to use either the most predominant risk characteristic or more than one predominant risk characteristic to stratify the servicing assets for purposes of evaluating and measuring impairment. An entity must exercise judgment when determining how to stratify servicing assets (that is, when selecting the most appropriate characteristic[s] for stratification). An entity may use different stratification criteria for the purposes of impairment testing under this Subtopic and for the purposes of grouping similar assets to be designated as a hedged portfolio in a fair value hedge under Subtopic 815-20. If an entity chooses not to restratify servicing assets for impairment testing...
under this Subtopic consistent with any restratification done for compliance with hedging criteria under Subtopic 815-20, the entity shall record any adjustments resulting from a fair value hedge to the risk strata used for impairment testing under paragraph 860-50-35-9.

35.14 Once an entity has determined the predominant risk characteristics to be used in identifying the resulting stratums within each class of servicing assets subsequently measured using the amortization method, that decision shall be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting stratums should be changed. If a significant change in economic facts and circumstances occurs, that change shall be accounted for prospectively as a change in accounting estimate in accordance with paragraphs 250-10-45-17 through 45-19 and 250-10-50-4.

Any impairment or increased servicing obligation (when applicable) should be recognized through a valuation allowance (or an increase in the servicing liability) for each individual stratum identified and analyzed. The amount of impairment recognized should be the amount by which the carrying amount of servicing assets for a stratum exceeds the fair value of that stratum. For servicing liabilities, the amount by which the estimated fair value of that stratum exceeds the corresponding carrying value would result in an increase to the existing liability.

The fair value of servicing assets not eligible for separate recognition should not be used in the evaluation of impairment. Stated another way, when evaluating each stratum for impairment (or increased obligation), similar but unrecognized servicing assets (or servicing liabilities) are not considered in the analysis of each recognized stratum of servicing asset or servicing liabilities. Similarly, it would not be appropriate to defer recognition of impairment in one recognized stratum by considering the unrealized appreciation in other recognized stratums. The impairment analysis should be performed on an individual stratum basis with consideration only of recognized servicing assets and liabilities, with no offsetting of gains and losses across stratums.

The relationship between a class of servicing assets and a related stratum(s) can be illustrated as follows:
ASC 860 does not prescribe specific guidance on how a class of servicing assets or servicing liabilities or related strata should be identified, but it does provide general guidelines (see ASC 860-50-35-5 and 35-9). In practice, we observe that strata generally are segregated and separately identified beyond the levels illustrated above.

For example, assume an entity originates residential mortgage loans all over the United States, with both fixed and floating interest rates. The entity securitizes its loan originations every six months and typically retains servicing contracts that provide more than adequate compensation. After the initial recognition of servicing assets, the entity elects the amortization method for subsequent accounting.

In this example, the servicing class may be broadly defined as all residential mortgages originated in the United States. One possible stratum within that class of servicing contracts may be for fixed mortgages originated in a specific region during a particular period (e.g., all residential mortgages originated in California in June 2010).

### 7.5.2.2 Valuation allowance versus write-downs

Recognized impairments of servicing assets should be recorded in a valuation allowance and adjusted for subsequent impairments. As noted in ASC 860-50-35-10, US GAAP does not address when a direct write-down (rather than through a valuation allowance) of impaired servicing assets should be recognized. Therefore, we believe, direct write-downs of the servicing asset is a matter of accounting policy that should be disclosed in the reporting entity’s significant accounting policies disclosures. An example of such a policy follows:

> “As noted above, the Company elects to subsequently measure certain mortgage servicing rights under the amortization method. These servicing rights are assessed for other-than-temporary impairment on a quarterly basis with any impairment recorded in a related mortgage servicing asset valuation account. The Company also quarterly reviews such impaired mortgage servicing rights to determine if a further impairment is necessary. Any subsequent impairments are also recorded to the valuation account. However, if circumstances indicate that the likelihood of future recovery of the impaired assets is remote, the Company will directly write-down such assets and relieve the valuation account.”

### 7.5.2.3 Examples illustrating servicing assets subsequently measured under the amortization method and tested for impairment

<table>
<thead>
<tr>
<th>Illustration 7-2: Application of the amortization requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company ABC holds a portfolio of acquired residential mortgage servicing rights, which the company has elected to subsequently measure under the amortization method in accordance with ASC 860-50-35-1(a).</td>
</tr>
<tr>
<td>A portion of the servicing portfolio consists of adjustable rate subprime residential mortgages that have the following specifications:</td>
</tr>
<tr>
<td>&gt; Total undiscounted net servicing income is estimated to be $52,000.</td>
</tr>
<tr>
<td>&gt; The initial fair value recorded for the servicing asset is $45,000.</td>
</tr>
<tr>
<td>The undiscounted net servicing income to be received in years one through four is estimated at $2,000, $1,980, $1,920 and $1,800, respectively. (For simplicity, only the first four years are shown; the total net undiscounted income of $52,000 includes all years comprising the weighted-average term of the loan pool.</td>
</tr>
</tbody>
</table>
The amortization amounts to be recorded in years one through four would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Undiscounted net servicing income</th>
<th>Cumulative undiscounted net servicing income</th>
<th>Current period amortization expense percentage*</th>
<th>Current period amortization expense</th>
<th>Cumulative amortization expense</th>
<th>Servicing asset carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2,000</td>
<td>2,000</td>
<td>3.85%</td>
<td>3.85%</td>
<td>$1,731</td>
<td>$43,269</td>
</tr>
<tr>
<td>2012</td>
<td>1,980</td>
<td>3,980</td>
<td>3.81%</td>
<td>7.65%</td>
<td>1,713</td>
<td>3,444</td>
</tr>
<tr>
<td>2013</td>
<td>1,920</td>
<td>5,900</td>
<td>3.69%</td>
<td>11.35%</td>
<td>1,662</td>
<td>5,106</td>
</tr>
<tr>
<td>2014</td>
<td>1,800</td>
<td>7,700</td>
<td>3.46%</td>
<td>14.81%</td>
<td>1,558</td>
<td>6,663</td>
</tr>
</tbody>
</table>

* Total estimated undiscounted net servicing income
Differences due to rounding

Note: Companies often determine the amount of the servicing asset (liability) to be amortized during a given period by calculating the undiscounted net servicing income (loss) for the period, divided by the total estimated undiscounted net servicing income (loss). The resulting percentage represents the amount of the originally recorded servicing asset (liability) to be amortized during the period. For this purpose, the same estimated undiscounted cash flows used in the fair value calculation should be used. The aforementioned methodology is only one example of an amortization method. Other methods may be appropriate. Importantly, a company would need to update its net undiscounted servicing revenues every reporting period and test for impairment.

Illustration 7-2(a): Application of the impairment provisions to servicing assets (liabilities) measured at amortized cost

This example builds on the assumptions in Illustration 7-2.

For purposes of measuring impairment (the excess of amortized cost of an individual stratum over its estimated fair value), Company ABC stratifies its mortgage servicing rights (MSR) based on the predominant risk characteristics of the underlying serviced loans, as follows:

- **Stratum A** – Fixed rate conventional residential mortgage loans originated in the mid-Atlantic region of the US with an average expected life of 11 years.
- **Stratum B** – Adjustable rate subprime residential mortgage loans originated in the southwest region of the US with an average expected life of 9 years.
- **Stratum C** – Hybrid-adjustable rate residential mortgage loans originated in the northeast region of the US with an average expected life of 7 years.
At 31 December 2012, Company ABC determines the MSR impairment to be $3,556, calculated as follows:

<table>
<thead>
<tr>
<th>Amortized carrying value</th>
<th>Stratum A</th>
<th>Stratum B</th>
<th>Stratum C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 63,912</td>
<td>$ 41,556</td>
<td>$ 176,253</td>
<td>$ 281,721</td>
<td></td>
</tr>
<tr>
<td>Estimated fair value</td>
<td>65,300</td>
<td>38,000</td>
<td>180,700</td>
<td>284,000</td>
</tr>
<tr>
<td>Fair value in excess (below) amortized carrying value</td>
<td>1,388</td>
<td>(3,556)</td>
<td>4,447</td>
<td>2,279</td>
</tr>
<tr>
<td>Required valuation allowance (or write-off)</td>
<td>0</td>
<td>(3,556)</td>
<td>0</td>
<td>(3,556)</td>
</tr>
</tbody>
</table>

1 Amortized carrying value as shown in Illustration 7-2

A valuation allowance (or write-off) is required for Stratum B because the fair value of the servicing asset is below its amortized carrying value. Importantly, even though the aggregate fair value of all MSRs exceeds their aggregate amortized carrying value, the unrecognized excess of fair value over carrying value attributed to Stratum A and C cannot be used to offset the deficit (impairment) in Stratum C (see ASC 860-50-35-9(b)).

If Company ABC believes Stratum B is temporarily impaired it will establish a valuation allowance of $3,556 and continue to recognize amortization expense based on the computations shown in the table in Illustration 7-2. However, if the impairment is considered to be other-than-temporary, the company would directly write down the servicing asset and recalculate the amortization schedule for the stratum’s adjusted carrying value based on the revised estimated undiscounted net servicing income.

<table>
<thead>
<tr>
<th>Year</th>
<th>Undiscounted net servicing income</th>
<th>Cumulative undiscounted net servicing income</th>
<th>Current period amortization expense percentage*</th>
<th>Cumulative amortization percentage*</th>
<th>Current period amortization expense</th>
<th>Cumulative amortization expense</th>
<th>Servicing asset carrying value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$ 1,757</td>
<td>$ 1,757</td>
<td>3.69%</td>
<td>3.69%</td>
<td>$ 1,403</td>
<td>$ 1,403</td>
<td>$ 36,597</td>
</tr>
<tr>
<td>2014</td>
<td>1,647</td>
<td>3,404</td>
<td>3.46%</td>
<td>7.15%</td>
<td>1,315</td>
<td>2,717</td>
<td>35,283</td>
</tr>
</tbody>
</table>

\[\text{Adjusted carrying value (at 31 December 2012)} = 38,000\]

\[\text{Adjusted carrying value (at 31 December 2012)} = \text{II (prior year)} + \text{I (current year)} + (\text{I})/\$47,600\]

\[\text{Cumulative amortization percentage*} = (\text{III}) \times (\text{VI}) + (\text{V}) \times (\text{VII})\]

\[\text{Cumulative amortization expense} = (\text{III}) \times (\text{VI}) + (\text{V}) \times (\text{VII})\]

\[\text{Servicing asset carrying value} = \text{Adjusted carrying value} - \text{Cumulative amortization expense}\]

A Revised total estimated undiscounted net servicing income

* Differences due to rounding

The following entry would be recorded by Company ABC if the impairment of the MSR is considered to be temporary:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 3,556</td>
<td>$ 3,556</td>
</tr>
</tbody>
</table>

Note: To establish a valuation allowance for temporarily impaired MSRs
The following amortization expense would be recorded by Company ABC if the impairment of the MSR is considered to be temporary:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization expense</td>
<td>$1,662</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>$1,662</td>
</tr>
</tbody>
</table>

The following additional entry would be recorded by Company ABC if the impairment of the MSR is considered to be other-than-temporary:

**31 December 2012**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSR charge-off</td>
<td>$3,556</td>
</tr>
<tr>
<td>Mortgage servicing rights (asset)</td>
<td>$3,556</td>
</tr>
</tbody>
</table>

**Note:** To reduce the carrying value of the MSR as a result of an other-than-temporary impairment

The following amortization expense would be recorded by Company ABC if the impairment of the MSR is considered to be other-than-temporary:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization expense</td>
<td>$1,403</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>$1,403</td>
</tr>
</tbody>
</table>

### 7.5.2.4 Obligation to service refinanced mortgage loans

ASC 860-50-35-17 and 35-18 provide further guidance regarding subsequent measurement for costs relating to acquiring the mortgage servicing asset and considerations for refinancing.

**Excerpt from Accounting Standards Codification**

**860-50-35**

35-17 When an entity that is servicing mortgage loans refinances a mortgage loan that is being serviced (resulting in prepayment of the old mortgage loan and origination of a new mortgage loan), the entity shall not consider the estimated future net servicing income (that is, servicing revenue in excess of servicing costs) from the new mortgage loan in determining how to amortize any capitalized cost related to acquiring the mortgage servicing asset for the old mortgage loan. The mortgage servicing asset represents a contractual relationship between the servicer and the investor in the mortgage loan, not between the servicer and the borrower.

35-18 The cost of a mortgage servicing asset that is subsequently measured using the amortization method may require adjustment as a result of the refinancing transaction depending on the servicer’s assumptions in recording the servicing asset. If the refinancing transaction represents prepayment activity anticipated by the servicer when the servicing asset was recorded, an adjustment would not be necessary. However, if actual prepayments differ from anticipated prepayments, an adjustment to the servicing asset would be required. If the servicing assets or liabilities are subsequently measured using the fair value measurement method, the entity shall recognize any adjustment as a result of the refinancing transaction directly in earnings.

See questions 7-7 and 7-8 for additional interpretive guidance.
7.6 Presentation

ASC 860-50-45-1 and 45-2 provides further guidance on other presentation matters as they relate to servicing assets and liabilities:

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-50-45</td>
</tr>
<tr>
<td>45-1 An entity shall report recognized servicing assets and servicing liabilities that are subsequently measured using the fair value measurement method in a manner that separates those carrying amounts on the face of the statement of financial position from the carrying amounts for separately recognized servicing assets and servicing liabilities that are subsequently measured using the amortization method.</td>
</tr>
<tr>
<td>45-2 To accomplish that separate reporting, an entity may do either of the following:</td>
</tr>
<tr>
<td>a. Display separate line items for the amounts that are subsequently measured using the fair value measurement method and amounts that are subsequently measured using the amortization method (^{[58]}) or</td>
</tr>
<tr>
<td>b. Present the aggregate of those amounts that are subsequently measured at fair value and those amounts that are subsequently measured using the amortization method (see paragraphs 860-50-35-9 through 35-11) and disclose parenthetically the amount that is subsequently measured at fair value that is included in the aggregate amount. (^{[59]})</td>
</tr>
</tbody>
</table>

| Illustration 7-3: Separate line item reporting method in accordance with ASC 860-50-45-2(a) |
| Statement of Financial Position |
| Servicing assets: |
| Measured at fair value | $ XXX |
| Amortized | XXX |

| Illustration 7-4: Aggregate reporting method in accordance with ASC 860-50-45-2(b) |
| Statement of Financial Position |
| Servicing assets (includes $XXX measured at fair value) | $ XXX |

\(^{58}\) EY note: See Illustration 7-3.

\(^{59}\) EY note: See Illustration 7-4.
Illustration 7.7: Sale of receivables with servicing obtained

The following example based on ASC 860-50-55-21 through 55-26 illustrates the initial accounting and recognition of a sale of financial assets that includes a servicing asset and an interest-only strip as part of the proceeds.

Entity A originates $1,000 of loans that yield 10 percent interest income for their estimated lives of nine years. Entity A transfers the loans to an unconsolidated entity (accounted for as a sale) and receives as proceeds $1,000 cash, a beneficial interest to receive 1 percent of the contractual interest on the loans (an interest-only strip receivable) and an additional 1 percent of the contractual interest as compensation for servicing the loans.

The fair values of the servicing asset and the interest-only strip receivable are $40 and $60, respectively.

Entity A’s (transferor’s) accounting for sale with the servicing obtained is illustrated below.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Proceeds</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
</tbody>
</table>

Net proceeds

<table>
<thead>
<tr>
<th>Gain on Sale</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds</td>
<td>$1,100</td>
</tr>
<tr>
<td>Less: Carrying amount of loans sold</td>
<td>1,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$ 100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debit</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Loans</td>
<td>$1,000</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: To record the transfer and to recognize interest-only strip receivable and servicing asset

In subsequent periods, the servicing asset will be amortized in proportion to, and over the period of estimated net servicing income and assessed for impairment based on fair value at each reporting date.
Illustration 7-5(a): Recognition of impairment on servicing assets subsequently measured using the amortization method

Assume the same fact pattern as in Illustration 7-5 and the following:

- In accordance with ASC 860-50-35-1, Entity A elects to subsequently measure the servicing asset using the amortization method.
- At the end of the current fiscal year, Entity A measures and recognizes a $20 impairment relating to the servicing asset.

There are two different scenarios, based on whether the impairment is considered temporary or other than temporary. For simplicity, the scenarios assume that the entire class is the unit of account measured for impairment.

- **Scenario 1:** Entity A concludes that the impairment is temporary and decides to recognize impairment through a valuation allowance that would be adjusted for subsequent impairments, if any. The amount of impairment ($20) recognized equals the excess of carrying amount over fair value of the servicing asset as of the measurement date. Entity A records an impairment through the following journal entry:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment of servicing assets (expense)</td>
<td>$ 20</td>
</tr>
<tr>
<td>Valuation allowance (contra asset)</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

Additional accounting considerations:

In subsequent periods, if the fair value of the servicing asset increases, ASC 860-50-35-9(c) clarifies that a valuation allowance should be adjusted to reflect changes in the measurement of impairment after the initial measurement of impairment. Subsequent changes in fair value which are in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized (i.e., once the valuation allowance is eliminated for that stratum, no further increases in fair value are recognized).

In case of servicing liabilities, ASC 860-50-35-11 clarifies that if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows relative to the cash flows previously projected, the servicer should revise its earlier estimates and recognize the increased obligation as a loss in earnings. Similar to the accounting for changes in a valuation allowance for an impaired asset, increases in the servicing obligation may be recovered, but the obligation cannot be reduced below the amortized measurement of the initially recognized servicing liability.

For subsequent measurement purposes, servicing assets or servicing liabilities will need to be assessed for impairment or increased obligation based on fair value at each reporting date.

- **Scenario 2:** Entity A concludes that the impairment is other than temporary impairment. Entity A has made an accounting policy election of recording any other than temporary impairment as a direct write down of the servicing asset. Following its accounting policy, the company writes down the impairment through earnings. The amount of impairment ($20) recognized is the excess of the carrying amount over fair value of the servicing asset as of the measurement date. Entity A records impairment through the following journal entry:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Write-off of servicing asset (expense)</td>
<td>$ 20</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>$ 20</td>
</tr>
</tbody>
</table>

Additional accounting considerations:

For subsequent measurement purposes, the new carrying amount of the servicing asset should be used to assess (at each reporting date) if subsequent impairments are required.
7.8 Accounting for transfers of servicing assets and servicing liabilities

Servicers of financial assets may transfer their contractual rights and obligations to a third-party servicers. Because servicing rights do not meet the definition of financial assets, the FASB developed alternative guidance for determining when it is appropriate to derecognize a servicing asset and servicing liability.

7.8.1 Conditions for sale accounting

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-50-40</td>
</tr>
<tr>
<td>40-2 The following criteria shall be considered when evaluating whether a transfer of servicing rights qualifies as a sale:</td>
</tr>
<tr>
<td>a. Whether the transferor has received written approval from the investor if required.</td>
</tr>
<tr>
<td>b. Whether the transferee is a currently approved transferor-servicer and is not at risk of losing approved status.</td>
</tr>
<tr>
<td>c. If the transferor finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the transferee’s commitment to pay the remaining sales price) and whether the note receivable from the transferee provides full recourse to the transferee. Nonrecourse notes or notes with limited recourse (such as to the servicing) do not satisfy this criterion.</td>
</tr>
<tr>
<td>d. Temporary servicing performed by the transferor for a short period of time shall be compensated in accordance with a subservicing contract that provides adequate compensation.</td>
</tr>
<tr>
<td>40-3 Also, the following additional criteria shall be considered when evaluating whether a transfer of servicing rights qualifies as a sale:</td>
</tr>
<tr>
<td>a. Title has passed.</td>
</tr>
<tr>
<td>b. Substantially all risks and rewards of ownership have irrevocably passed to the buyer.</td>
</tr>
<tr>
<td>c. Any protection provisions retained by the seller are minor and can be reasonably estimated.</td>
</tr>
<tr>
<td>40-4 If a sale is recognized and minor protection provisions exist, a liability shall be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if both of the following conditions are met:</td>
</tr>
<tr>
<td>1. The obligation associated with those provisions is estimated to be no more than 10 percent of the sales price.</td>
</tr>
<tr>
<td>2. Risk of prepayment is retained for no longer than 120 days.</td>
</tr>
<tr>
<td>40-5 A temporary subservicing contract in which the subservicing will be performed by the transferor for a short period of time would not necessarily preclude recognizing a sale at the closing date.</td>
</tr>
</tbody>
</table>

The accounting requirements specified in ASC 860-50-40-2 through 40-4 apply to transfers of servicing rights relating to financial assets previously sold and to transfers of servicing rights relating to financial assets that are retained by the transferor. Some of those requirements are further discussed below.
7.8.1.1 Seller financing

Occasionally a transferor (seller) finances a portion of the sales price for the transferee. Such an arrangement may preclude sale accounting for the transferred servicing rights if, as a result of the financing, substantially all of the risks and rewards of ownership have not irrevocably passed to the transferee. However, a financing arrangement that requires the transferee to make a substantive non-refundable down payment (i.e., sufficient to demonstrate the transferee’s commitment to pay the remaining sales price) and provides the transferor full recourse to the transferee, would not, in itself, preclude sale accounting. For purposes of this analysis, we believe the following factors, among others, should be considered:

- The relationship between the transferor and the transferee
- The transferee’s ability to repay the financing
- The transferor’s intent to pursue collection if the transferee fails to repay the financing
- The magnitude of the down payment
- The terms of the financing (a shorter-term amortizing loan versus a longer-term non-amortizing loan) and the amount by which the fair value of the servicing could decline during the period
- Whether the amounts the seller stands to lose exceed any reasonably estimated costs of litigation or profits (or reduced loss) that may be realized from an alternative willing buyer (assuming other willing buyers exist in the marketplace)

7.8.1.2 Temporary sub-servicing

In transfers of servicing rights, the transferor typically continues to temporarily service the underlying financial assets during the period that the parties enter into an agreement to sell servicing rights and the time the loan portfolio to be serviced is actually delivered (the transition period). Generally, the transition period is between three to six months and is necessary to accommodate the transferor’s (seller’s) inability to immediately transfer servicing records and loan files or the transferees (buyers) inability to immediately accept delivery. Other factors that typically delay transfer of servicing rights include difficulties in obtaining necessary investor approval and requirements to give advance notification to borrowers, among other considerations.

ASC 860-50-40-5 clarifies that sub-servicing performed by the transferor in accordance with a servicing right at a rate that provides adequate compensation during the transition period does not in itself preclude recognition of the transfer of servicing rights as a sale. Under those circumstances, assuming the sub-servicing is temporary, substantially all of the risks and rewards of ownership are still presumed to pass to the buyer if the other conditions for recognizing a transfer are met.

7.8.1.3 Minor protection provisions

Agreements to sell or transfer servicing rights may contain protection provisions that could affect the amount ultimately paid to the seller. For example, the seller may agree to adjust the sales price for loan prepayments, defaults or foreclosures that occur within a specified period of time. Most of the agreements also contain representation and warranty provisions covering eligibility defects discovered within specified time periods. If any minor protection provisions (effectively any recourse obligations retained by the transferor) exist, a liability for such provisions should be accrued. If such liability is more than 10% of the sales price, or if the transferor retains prepayment risks (prepayment of the underlying financial assets) for greater than 120 days from the date of closing, then the transfer does not qualify as a sale (see ASC 860-50-40-4).
Transfers of servicing rights with sub-servicing retained

In some circumstances, a servicer may transfer its servicing rights for certain financial assets to an unrelated party at an economic gain. However, that transferee may not have the facilities or may elect to not perform the required servicing functions and, accordingly, enters into a sub-servicing agreement with the transferor. In this situation, the transferor will continue to perform the same servicing functions, now as a sub-servicer that it was providing immediately prior to the sale.

In these situations, it may not be apparent whether this type of transfer should be recognized as a sale or as a borrowing and, if recognized as a sale, whether any resulting gain should be deferred. A primary difficulty in resolving this question is determining if this transaction is effectively a financing because the transaction has only changed the cash flows relating to the servicing rights, and the transferor is still required to perform the servicing. Further, if the transaction were to be deemed a sale, it may be difficult to determine which portion of the proceeds relates to the sale of the servicing rights and which relates to future servicing obligations. ASC 860-50-40-7 provides relevant guidance for these circumstances:

Excerpt from Accounting Standards Codification
860-50-40-7
A sale of mortgage servicing rights with a subservicing contract shall be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the transferee, as discussed in paragraph 860-50-40-3. Attributes of the transferee (for example, ability to perform servicing) would not be significant to the accounting for the transaction. The risks and rewards associated with a transferor performing purely administrative functions under a subservicing contract would not necessarily preclude sales treatment. A loss shall be recognized currently if the transferor determines that prepayments of the underlying mortgage loans may result in performing the future servicing at a loss.

The FASB determined that if substantially all of the risks and rewards of ownership of the servicing rights have been transferred to the transferee, the transferor should derecognize the servicing asset or servicing liability, and any gain should be deferred and recognized over the term of the sub-servicing contract. ASC 860-50-40-8 provides factors that suggest that transfers of servicing rights with a subservicing agreement are more representative of financing transactions.

Excerpt from Accounting Standards Codification
860-50-40-8
Substantially all the risks and rewards inherent in owning the mortgage servicing rights have not been transferred to the transferee and, therefore, the transaction shall be accounted for as a financing if any of the following factors are present:

a. The transferor-subservicer directly or indirectly guarantees a yield to the transferee. For example, the transferor-subservicer guarantees prepayment speeds or maximum loan default ratios to the buyer.
b. The transferor-subservicer is obligated to advance a portion or all of the servicing fees on a nonrecoverable basis to the transferee before receipt of the loan payment from the mortgagor.
c. The transferor-subservicer indemnifies the transferee for damages due to causes other than failure to perform its duties under the terms of the subservicing contract.

60 Although ASC 860-50-40-7 specifically refers to mortgage servicing rights, we believe that accounting guidance is applicable to all transfers of servicing rights with a subservicing contract.
d. The transferor-subservicer absorbs losses on mortgage loan foreclosures not covered by the Federal Housing Administration, Department of Veterans Affairs, or other guarantors, if any, including absorption of foreclosure costs and costs of managing foreclosed property.

e. Title to the servicing rights is retained by the transferor-subservicer.

Additionally, ASC 860-50-40-9 provides further guidance on factors which may create a rebuttable presumption that substantially all the risks and rewards inherent in owning the servicing rights have not been transferred.

**Excerpt from Accounting Standards Codification**

**860-50-40-9**

The presence of any of the following factors creates a rebuttable presumption that substantially all the risks and rewards inherent in owning the servicing rights have not been transferred to the transferee and that the transaction should be accounted for as a financing:

a. The transferor-subservicer directly or indirectly provides financing or guarantees the transferee’s financing. Nonrecourse financing, for example, would indicate that risks have not been transferred to the transferee. Topic 450 requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee.

b. The terms of the subservicing contract unduly limit the transferee’s ability to exercise ownership control over the servicing rights or result in the seller’s retaining some of the risks and rewards of ownership. For example, if the transferee cannot cancel or decline to renew the subservicing contract after a reasonable period of time, the transferee is precluded from exercising certain rights of ownership. Conversely, if the transferor cannot cancel the subservicing contract after a reasonable period of time, the transferor has not transferred substantially all of the risks of ownership.

c. The transferee is a special-purpose entity without substantive capital at risk.

See question 7-9 for additional interpretive guidance.

### 7.8.3

**Sales of servicing rights for participation in an income stream**

An entity may sell the right to service loans that are owned by other parties or loans that have been previously sold, with servicing retained, in a separate transaction. In these transactions, the servicing rights can be sold for immediate cash or for a participation in the future interest stream of the loans.

These arrangements raise questions about whether a gain should be recorded on the sale of the servicing rights when the sale is for participation in the future interest income stream and, if a gain is recognized, how that gain should be measured. ASC 860-50-40-11 provides the following guidance for such circumstances:

**Excerpt from Accounting Standards Codification**

**860-50-40-11**

If a transfer of mortgage servicing rights qualifies as a sale under the criteria beginning in paragraph 860-50-40-2 and the sale is for a participation in the future interest income stream, gain recognition is appropriate at the sale date. There are difficulties in measuring the amount of the gain if the sales price is based on a participation in future payments and there is no specified upper limit on the computed sales price. The transferor of mortgage servicing rights shall consider all available information, including the amount of gain that would be recognized if the servicing rights were to be sold outright for a fixed cash price.
Questions and interpretive responses

Question 7-1  Initial recognition requirements

Assume an entity that originates loans on a “flow” basis – by acting as an origination agent for a third party that funded and legally owns the loans – also enters into a servicing contract to service the loans for the third party. Should the entity recognize a servicing asset or servicing liability even though it did not own, transfer or securitize the loans that it is servicing?

Yes. ASC 860-50-25-1 requires that a servicing asset or a servicing liability should be recognized any time a servicer acquires or assumes a servicing contract that does not relate to financial assets of the servicer or its consolidated affiliates included in the financial statements.

Question 7-2  Revolving-period securitizations

Do additional transfers under revolving-period securitizations result in the recognition of additional servicing assets or servicing liabilities?

Yes. ASC 860-50-25-9 requires that servicing assets or servicing liabilities for revolving-period receivables should be recognized only for the receivables that exist and have been sold. As new receivables are sold, rights to service them may become assets or liabilities that are recognized. Therefore, additional transfers under revolving-period securitizations (for example, home equity loans or credit card receivables) may result in the recognition of additional servicing assets or servicing liabilities.

Question 7-3  Initial recognition if the servicing contract has no specified fee

Should an entity recognize a servicing liability (and a loss on its income statement) if it transfers a financial asset that is accounted for as a sale and assumes an obligation to service the financial asset but receives no contractually specified servicing fee?

Yes. ASC 860-50-55-5 indicates that in the circumstances described, the transferor-servicer would be required to recognize a servicing liability at fair value if the benefits of servicing are less than adequate compensation. The requirements in paragraph 860-50-25-1 apply even if it is not customary to charge a contractually specified servicing fee. Example 1, Case C (paragraph 860-50-55-25) illustrates a transaction in which a transferor agrees to service loans without explicit compensation.

Question 7-4  Servicing assets assumed without cash payment

When servicing assets are assumed without cash payment, what is the appropriate offsetting entry by the transferee?

ASC 860-50-55-7 states that the offsetting entry depends on whether an exchange or capital transaction has occurred. If an exchange has occurred, the transaction should be recorded based on the facts and circumstances. For example, the servicing asset may represent consideration for goods or services provided by the transferee to the transferor of the servicing. In that case, the offsetting entry by the transferee would be the same as if cash was received in exchange for the goods and services (that is, revenue or a liability as appropriate).

The servicing assets also might be received in full or partial satisfaction of a receivable from the transferor of the servicing. In those cases, the offsetting entry by the transferee would be to derecognize all or part of the receivable satisfied in the exchange. Another possibility is that an investor is in substance making a capital contribution to the investee (the party receiving the servicing asset, that is, the transferee) in exchange for an increased ownership interest. In that case, the investee should recognize an increase in equity from a contribution by owner.
Question 7-5  
Transfer of a participating interest with servicing retained

Should an entity recognize a servicing asset or servicing liability if it transfers a portion of a financial asset that meets the definition of a participating interest that is accounted for as a sale, retains at least some of the remaining participating interests and undertakes an obligation to service?

Yes. The selling entity would be required to record a servicing asset or servicing liability for that portion of the financial asset sold, provided that the benefits of servicing are not equal to adequate compensation, as described in ASC 860-50-55-4.

If the entity that transfers a portion of a loan under a participation agreement that meets the definition of a participating interest and qualifies for sale accounting under Subtopic 860-10 obtains the right to receive benefits of servicing that more than adequately compensate it for servicing the loan, and the entity would continue to service the loan regardless of the transfer because it retains part of the participated loan, ASC 860-50-55-4 requires the entity to record a servicing asset for the portion of the loan it sold. The assumption that the entity would service the loan because it retains part of the participated loan does not affect the requirement to recognize a servicing asset. Conversely, an entity could not avoid recording a servicing liability if the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing.

However, if the benefits of servicing are significantly above an amount that would fairly compensate a substitute service provider, should one be required, the transferred portion does not meet the definition of a participating interest, and, therefore, the transfer does not qualify for sale accounting (see paragraph 860-10-40-6A(b)).

Question 7-6  
Incorporating ancillary sources of cash flows into a fair value measurement

How does the existence of the right to receive future cash flows from ancillary sources such as late fees affect the measurement of a servicing right?

The value of a right to potential future cash flows derived from ancillary sources of income (float, late fees, etc.) should be factored into the estimated fair value of a servicing contract because such benefits directly affect the fair value of the servicing rights. However, like all other inputs and assumptions, such factors should be based on a market participant’s expectations.

Question 7-7  
Evaluating impairments

ASC 860-50-35-1 requires that entities separately evaluate and measure impairment of designated strata of servicing assets within classes of servicing assets that are subsequently measured using the amortization method. Must those classes of servicing assets be stratified based on more than one predominant risk characteristic of the underlying financial assets if more than one characteristic exists?

No. ASC 860-50-35-9 requires servicers to “stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets” for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Therefore, ASC 860-50 does not require that either the most predominant risk characteristic or more than one predominant risk characteristic be used to stratify the servicing assets for purposes of evaluating and measuring impairment. A servicer must exercise judgment when determining how to stratify servicing assets (i.e., when selecting the most appropriate characteristic(s) for stratification). Such judgments should be based on the characteristics that will result in strata whose fair values respond similarly to changes in input assumptions.

61 See also section 7.3.5 and section 2.3.1.
Question 7-8  Consistent application of stratums

ASC 860-50-35-9 requires a servicer to stratify servicing assets within a class based on one or more of the predominant risk characteristics of the underlying financial assets for classes of servicing assets that a servicer elects to subsequently measure using the amortization method. Should the stratums selected by the servicer be used consistently from period to period?

Generally, yes. ASC 860-50-35-14 clarifies that once an entity has determined the predominant risk characteristics to be used in identifying the resulting stratums within each class of servicing assets subsequently measured using the amortization method, that decision should be applied consistently unless significant changes in economic facts and circumstances clearly indicate that the predominant risk characteristics and resulting stratums should be changed. If a significant change in economic facts and circumstances occurs, that change should be accounted for prospectively as a change in accounting estimate in accordance with ASC 250-10-45-17 through 45-20. If the predominant risk characteristics and resulting stratums are changed, that fact and the reasons for those changes should be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with ASC 860-50.

Question 7-9  Subservicing contracts

A transferor transfers mortgage loans in their entirety to a third party in a transfer that is accounted for as a sale but undertakes an obligation to service the loans. After the transfer, the transferor enters into a subservicing arrangement with a third party. How should the transferor account for the obligation to service as a result of those transactions?

ASC 860-50-55-11 states that if the transferor’s benefits of servicing exceed its obligation under the subservicing contract, that differential shall not be accounted for as an interest-only strip. Rather, the transferor should account for the two transactions separately. First, the transferor should account for the transfer of mortgage loans in accordance with ASC 860-20. The obligation to service the loans should be initially recognized and measured at fair value according to paragraph 860-50-30-1 as proceeds obtained from the sale of the mortgage loans. Second, the transferor should account for the subcontract with the subservicer.

ASC 860-50-40-2 through 40-5 provides applicable guidance to determine whether the transfer of servicing rights to the subservicer should be recognized as a sale. ASC 860-50-40-7 through 40-11 provides incremental accounting guidance if the transferor retains sub-servicing.
8  Secured borrowings and collateral

8.1  Introduction

This chapter provides guidance on (a) when a transfer should be accounted for as a secured borrowing, (b) the general accounting model for secured borrowings and (c) how collateral should be recognized.

8.2  Secured borrowings

If a transfer of financial assets fails to meet any of the derecognition conditions in ASC 860-10-40-5, both the transferor and transferee are required to account for the transfer as a secured borrowing. For the transferor, the transaction should be accounted for as follows:

- Continue to report the transferred financial assets in the statement of financial position with no change in their measurement (i.e., the basis of accounting does not change – see ASC 860-30-25-2)
- Recognize the cash or other consideration received as an asset and an offsetting liability for the secured borrowing arrangement
- Account for the collateral pledged (cash or noncash) in accordance with ASC 860-30-25 (discussed further below)
- Contractual rights or obligations related to the transferred asset are not accounted for separately if doing so would result in recognizing the same rights or obligations twice (e.g. a call option retained by the transferor may prevent a transfer from being accounted as a sale so the call option is not separately recognized as a derivative asset); refer to ASC 815-10-15-63
- In subsequent periods, recognize any income on the transferred assets and any expense incurred on the liability

The transferee in a secured borrowing transaction does not recognize the transferred asset as its asset. Instead, the transferee generally derecognizes cash paid to the transferor and recognizes a receivable (or loan) from the transferor.

In a secured borrowing transaction, the collateral granted by the transferor to the transferee may be in the form of cash or noncash amounts (e.g., securities), and may include recourse to other assets of the transferor.

The following example illustrates the accounting for a transfer of financial assets, in exchange for cash, that is treated as a secured borrowing because it fails to meet all of the derecognition conditions of ASC 860-10-40-5.

**Illustration 8-1: Transfer of financial asset in exchange for cash accounted for as a secured borrowing**

On 1 January 2011, Company A transfers a commercial loan with a carrying amount of $1,000, yielding 10% and maturing on 31 December 2011 to Company B (an unconsolidated operating entity) in exchange for a cash payment of $1,050. The transfer fails the derecognition requirements of ASC 860-10-40-5(a) because Company B is not allowed to pledge or resell the transferred loan.
The transaction should be accounted for as a secured borrowing with a pledge of collateral (i.e., the commercial loan is pledged as collateral). No gain or loss is recognized on the transfer. The cash received from Company B would be recognized as an asset with an offsetting obligation to settle the amounts borrowed. The transferred loan would remain on Company A’s balance sheet with no change in the basis of accounting.

**Balance sheet comparison**

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ –</td>
<td>$ 1,050</td>
</tr>
<tr>
<td>Commercial loan</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$ 1,000</td>
<td>$ 2,050</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Obligation under secured borrowing arrangement</td>
<td>$ –</td>
<td>$ 1,050</td>
</tr>
<tr>
<td>Equity</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$ 1,000</td>
<td>$ 2,050</td>
</tr>
</tbody>
</table>

**Journal entries**

**1 January 2011**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 1,050</td>
</tr>
<tr>
<td>Obligation under secured borrowing arrangement</td>
<td>$ 1,050</td>
</tr>
</tbody>
</table>

*Note:* To recognize cash received and record a liability for the commercial loan transfer that does not meet the requirements for sale accounting

Subsequent to the transfer, Company A would continue to recognize the interest income on the commercial loan as if it still held the loan. Additionally, the obligation to Company B should be accreted using the effective interest rate method\(^{62}\) so that the liability eventually would equal the face amount of the commercial loan due on the maturity date. That is, the obligation to Company B would accrete from $1,050 (the amount received from Company B) to $1,100 (the maturity value of the commercial loan, which includes a principal amount of $1,000 and annual interest of $100). The following entries would be recorded by Company A:

**Year ended 31 December 2011**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial loan</td>
<td>$ 100</td>
</tr>
<tr>
<td>Interest income</td>
<td>$ 100</td>
</tr>
</tbody>
</table>

*Note:* To recognize the annual interest income on the commercial loan ($1,000 x 10%)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$ 50</td>
</tr>
<tr>
<td>Obligation under secured borrowing arrangement</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

*Note:* To recognize the accretion of interest expense on the obligation to Company B ($1,100 (liability’s maturity value) – $1,050 (liability’s initial carry value))

**31 December 2011**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligation under secured borrowing arrangement</td>
<td>$ 1,100</td>
</tr>
<tr>
<td>Commercial loan</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

*Note:* To recognize the maturity of the commercial loan and discharge of the obligation to Company B

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\(^{62}\) Refer to ASC 835-30 for further guidance on imputing interest for subsequent measurement purposes.
8.3 Accounting for collateral

8.3.1 Cash collateral

Transfers of financial assets in exchange for cash collateral (consideration for transferred financial assets) cannot be distinguished from borrowing cash. Accordingly, ASC 860-30-25-3 requires that all cash collateral be recorded as an asset by the party receiving it, together with a liability for the obligation to return it to the payer (the transferee). The transferee derecognizes the cash collateral surrendered to the transferor, because it a fungible asset that makes it impossible to determine whether it has been used by the transferor, and recognizes a receivable from the transferor.

See Illustration 9-1 in section 9.6.1 for an example of a securities lending arrangement accounted for as a secured borrowing in exchange for cash.

8.3.2 Noncash collateral

Excerpt from Accounting Standards Codification

860-30-25-5

The accounting for noncash collateral by the obligor (or debtor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the obligor has defaulted. Noncash collateral shall be accounted for as follows:

a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then paragraph 860-30-45-1 requires that the obligor (transferor) reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Topic.

c. If the obligor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset as required by paragraph 860-30-40-1[63] and the secured party (transferee) shall recognize the collateral as its asset. (See paragraph 860-30-30-1[64] for guidance on the secured party’s initial measurement of collateral recognized. See paragraph 860-30-40-1 for further guidance if the debtor has sold the collateral.)

d. Except as provided in paragraph 860-30-40-1 the obligor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

---

63 EY note: ASC 860-30-40-1 indicates that in circumstances where an obligor (transferor) transfers noncash collateral in a secured borrowing and the obligor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, the obligor should derecognize the pledged asset. If the secured party has already sold the collateral, the secured party should derecognize its obligation to return the collateral.

64 EY note: ASC 860-30-30-1 requires that noncash collateral recognized by the secured party as its asset under ASC 860-30-25-5(c) that the secured party has not already sold should be initially measured at fair value.
The following decision tree illustrates the accounting requirements for transfers of noncash collateral pursuant to ASC 860-30-25-5:

**Accounting for noncash collateral decision tree**

1. **Transferor (debtor):** Derecognize the collateral pledged to the transferee from its balance sheet.

2. **Transfer (secured party):** Recognize the collateral received from the transferor as its own asset, initially measured at fair value. If it has already sold the asset, derecognize the obligation to return the collateral.

3. Has the transferor (debtor) defaulted under the contract and therefore, is no longer entitled to redeem the pledged collateral? [ASC 860-30-25-5(c)]

   - No
     - Does the secured party (transferee) have the right by contract or custom to sell or repledge the collateral? [ASC 860-30-25-5(a)]
       - No
         - **Transferor (debtor):** No separate accounting for collateral (i.e., assets remain on balance sheet); disclosures of the arrangement is required.
         - **Transferee (secured party):** No accounting required.
       - Yes
         - **Transferor (debtor):** Reclassify collateral pledged as a separate asset (e.g., security pledged to creditor) and report separately from other assets not so encumbered.
         - **Transferee (secured party):** No accounting required.
     - Yes
       - **Transferor (debtor):** Reclassify collateral pledged as a separate asset (e.g., security pledged to creditor) and report separately from other assets not so encumbered.
       - **Transferee (secured party):** Recognize proceeds from the sale and the obligation to return the collateral.

4. Has the secured party (transferee) sold the collateral pledged to it? [ASC 860-30-25-5(b)]

   - No
     - Initial exchange of collateral
   - Yes
     - Initial exchange of collateral

---

1 Pursuant to ASC 860-30-25-5(d), the transferee (secured party) should not recognize the collateral pledged by the transferor.

2 Obligations to return to the transferor assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased. ASC 860 does not require any change in that practice (ASC 860-30-25-10).

**8.4 Other collateral accounting considerations**

**8.4.1 Pledged collateral assets required to be reclassified**

A transferor that has transferred collateral that must be reclassified in accordance with ASC 860-30-25-5(a) should not change its measurement of that collateral. The transferor should follow the same measurement principles as before the transfer (see ASC 860-30-35-2). For example, securities reclassified from the available-for-sale category to securities pledged to creditors should continue to be measured at fair value, with changes in fair value reported in comprehensive income, while debt securities reclassified from the held-to-maturity category to securities pledged to creditors should continue to be measured at amortized cost.
8.4.2 Obligation to return transferred collateral

ASC 860 does not provide specific guidance on the subsequent measurement of the obligation to return transferred collateral. The liability to return the collateral should be measured in accordance with other relevant accounting pronouncements. For example, a bank or savings institution that, as a transferee, sells transferred collateral is required to subsequently measure that liability at fair value similar to a short sale. The guidance in ASC 942-405-35-1 clarifies that the obligations incurred in short sales should be subsequently measured at fair value through the statement of operations at each reporting date.

8.4.3 Securities received as collateral in a securities lending arrangement

In a securities lending transaction, the transferor (debtor) must recognize receipts of noncash collateral (e.g., securities) that may be sold or re-pledged regardless of whether the transfer is accounted for as a sale or a secured borrowing. Specifically, as described in ASC 860-30-25-8, the collateral received under such circumstances is considered proceeds from the transfer and therefore is recognized by the transferor with a corresponding obligation to return the collateral received. Refer to Chapter 9, Securities lending, repurchase agreements and repurchase financing arrangements, for additional guidance on accounting for securities lending transactions and repurchase agreements.

8.5 Statement of financial position presentation considerations

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td>860-30-45</td>
</tr>
<tr>
<td>45-1 If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the obligor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.</td>
</tr>
<tr>
<td>45-2 Liabilities incurred by either the secured party or obligor in securities borrowing or resale transactions shall be separately classified.</td>
</tr>
<tr>
<td>45-3 This Section does not specify the classification or the terminology to be used to describe the following:</td>
</tr>
<tr>
<td>a. Pledged assets reclassified by the transferor of securities loaned or transferred under a repurchase agreement accounted for as a secured borrowing if the transferee is permitted to sell or repledge those securities</td>
</tr>
<tr>
<td>b. Liabilities incurred by either the secured party or obligor in securities borrowing or resale transactions.</td>
</tr>
</tbody>
</table>

Example 1 (see paragraph 860-30-55-1) illustrates possible classifications and terminology.
9 Securities lending, repurchase agreements and repurchase financing arrangements

9.1 Overview

In the capital markets, securities rarely lie idle. If not being purchased and sold in outright market transactions, securities are frequently lent to parties wanting to borrow them, or used as collateral to meet short-term cash needs. These transactions include repurchase agreements and securities lending transactions.

Repurchase agreements and securities lending involve the temporary exchange of securities, usually for other securities or cash of an equivalent value (or occasionally a mixture of cash and securities), with an obligation to redeliver a like quantity of the same or similar securities at a future date. Most repurchase agreements and securities lending transactions are structured to give the transferee legal title to the securities for the life of the transaction, even though, economically, the terms are more akin to a loan.

Repurchase agreements and securities lending transactions are difficult to characterize because those transactions have attributes of both sales and secured borrowings. Although repurchase agreements and securities lending transactions typically are treated as sales under US bankruptcy and tax laws (but only as they relate to income distributions), those arrangements generally are recorded as secured borrowings for accounting purposes because the transferor maintains “effective control” over the transferred financial assets.

This chapter provides an overview of securities lending transactions and repurchase agreements. It describes the market participants, the typical structure of these secured borrowing arrangements, and the underlying motivations for entering into such transactions. Additionally, this chapter includes a discussion of the concept of “effective control” under ASC 860-10-40-5(c)(1), including the accounting requirements for when effective control is maintained or surrendered. Lastly, this chapter addresses the circumstances under which a repurchase agreement that relates to a previously transferred financial asset between the same counterparties, that is entered into contemporaneously with, or in contemplation of, the initial transfer (a “repurchase financing”) should be evaluated separately or together with the initial transfer. This is an important consideration because an initial transfer of financial assets generally would fail the requirements of sale accounting when the transfer is “linked” with a repurchase financing.

9.2 Securities lending transactions

Securities lending transactions typically are initiated by securities dealers, broker-dealers and other financial institutions that need specific securities to make deliveries, either to cover a short sale or a customer’s failure to deliver securities sold. Borrowers of securities generally are required to provide collateral to the lender of securities, which is commonly cash, but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities typically earns a return by investing that cash at rates higher than the rate paid or rebated to the borrower of securities. If the collateral is other than cash, the lender of securities typically receives a fee.
9.2.1 Types of securities lending transactions

There are two somewhat distinct securities lending markets: “securities-driven” and “cash-driven.”

In the securities-driven market, firms seek to gain temporary access to specific securities. This may be because they have failed to receive securities that they are due to make delivery on or because they have deliberately sold a security short and are using the securities obtained through the loan to deliver against this position. The securities borrower will usually give collateral to the lender in the form of other securities, cash or a bank letter of credit. Collateral mitigates the lender’s exposure to the credit risk on the borrower.

In the cash-driven market, firms post securities as collateral to obtain cash financing. The cash lender is not seeking specific securities and will generally allow the cash borrower to select which securities to provide as collateral within defined categories of “general collateral,” for instance, all domestic government securities issues. Market participants use these transactions to finance their portfolios at rates generally below the interbank short-term uncollateralized lending rate.

In both securities-lending markets, any margin (discussed further in section 9.4) is usually provided by the provider of collateral, which value should exceed that of the cash or securities loaned. Therefore, in the cash-driven market, margin gives a measure of protection against adverse movements in market prices to the cash lender. In the securities-driven market, margin protects the securities lender against non-delivery.

9.2.2 Defining the lender and borrower in a typical securities lending transaction

Schematic of a typical securities lending transaction

<table>
<thead>
<tr>
<th>Transferor (Under US GAAP, the securities lender is considered the debtor or obligor)</th>
<th>Transferee (Under US GAAP, the securities borrower is considered the creditor or secured party)</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>b</td>
</tr>
<tr>
<td>Securities loaned</td>
<td>Return of securities loaned</td>
</tr>
<tr>
<td>Collateral (cash or securities)</td>
<td>Return of collateral (cash or securities)</td>
</tr>
</tbody>
</table>

**a. Transaction date** — the onset of the securities lending transaction. On this date, the transferor loans securities to the transferee in return for collateral that could be in the form of cash or securities.

**b. Settlement date** — the conclusion of the securities lending transaction. On this date, the transferee returns the loaned securities to the transferor along with the loan fee (if the transferee provided non-cash collateral, e.g., securities) and simultaneously the transferor returns the collateral (cash or securities) to the transferee along with the rebate fee if the collateral is cash.

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During the term of the transaction, dividends or interest on securities are paid by the issuer to the current security holder (i.e., the party that holds the securities transferred in the securities lending transaction), while the transferor may have only the contractual right to receive from the transferee payments in lieu of dividends or interest. In addition, the voting rights reside with the current security holder because those rights generally cannot be contractually released. Although the rights and obligations are described in the context of a securities lending transaction, the same occurs in a repurchase agreement.
The accounting for securities lending transactions can be confusing because ASC 860 and the marketplace view the lender and the borrower differently. While the marketplace views the party who borrows the security as a debtor and the party who provides the security as the lender, ASC 860 views the security lender as a debtor who borrowed the collateral received and the party who has legally borrowed the security as the lender. The terms “transferor,” “debtor” and “obligor” all refer to the transferor-lender of the securities who, for accounting purposes, is viewed as entering into a borrowing for which it provided collateral in the form of loaned securities. The terms “transferee,” “creditor” and “secured party” all refer to the party providing cash, securities, or standby letters of credit in exchange for the transferred securities. These terms are identical to the terminology used in ASC 860-30-05 and elsewhere in ASC 860.

See section 9.6 for additional accounting guidance.

9.3 Repurchase agreements

Many financial institutions that purchase fixed income securities finance such purchases through repurchase agreements. In repurchase agreements, the transferor (also referred to as the “repo party” or “seller-borrower”) transfers a security to a transferee (also referred to as the “reverse repo party” or “buyer-lender”) in exchange for cash and simultaneously agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus an interest factor.

Typical repurchase agreements could be described as the “repo party” borrowing funds using the securities as collateral. Government securities dealers, banks and others commonly use repurchase agreements to obtain or invest short-term funds. For the “reverse repo party,” a repurchase agreement is an opportunity to invest cash (secured by collateral) for a period. Many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. Some repurchase agreements allow for repurchase of securities that need not be identical to the securities transferred. For entities engaged in trading activities, repurchase agreements are used to finance long positions, obtain access to cheaper funding and cover short positions in securities.

Schematic of a typical repurchase agreement

<table>
<thead>
<tr>
<th>Transferor (or repo party or seller-borrower)</th>
<th>Transferee (or reverse repo party or buyer-lender)</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="chart.png" alt="Diagram" /></td>
<td><img src="chart.png" alt="Diagram" /></td>
</tr>
</tbody>
</table>

| a. Transaction date – the onset of the repurchase agreement. On this date, the transferor borrows cash and provides collateral in the form of securities to the transferee. |
| b. Settlement date – the conclusion of the repurchase agreement. On this date, the transferor repays the borrowed cash along with the repo fee to the transferee and simultaneously the transferee returns the collateral (securities) to the transferor. |

66 There is some diversity regarding how the term repo and reverse repo are used. Banks, insurance companies, broker dealers and other financial institutions use the term “repo” to refer to sales and repurchases and “reverse repo” to refer to purchases and resales, while investment companies use the same terminology to refer to reciprocal transactions (i.e., they use the reciprocal term “repo” to refer to purchases and resales and “reverse repo” to sales and repurchases).

67 See footnote 65.
Under a typical repurchase agreement, the initial valuation and transfer of securities is based on the current market price, including a component for accrued interest. When a repurchase agreement is terminated, the securities are re-sold at a pre-determined price. This price is comprised of two different components, the original sale price, plus a previously determined interest rate, which is also known as the “repo rate.” The difference between the initial transfer and repurchase price is a lending interest rate for the secured borrowing. The repo rate is dependent on the quality of collateral (e.g., the rate for generic government securities is lower than rates for bonds rated BBB). The rate is also impacted by demand for a certain security in the market (i.e., higher for a security which is in greater demand). The creditworthiness of the borrower may also affect the rate (although this tends to affect the level of collateral required rather than the interest earned by the lender as compensation).

Repurchase agreements can take different forms including specified delivery, tri-party and held-in-custody arrangements. They can also have different terms. For example, some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or re-pledge the securities to a third party during the term of the repurchase agreement while others do not.

### 9.3.1 Types of repurchase agreements

**Specified delivery**

In specified delivery agreements, the delivery of a pre-specified security is required at the onset of the agreement (e.g., the transaction date) and at conclusion of the contractual period (e.g., the settlement date).

**Tri-party**

Tri-party repurchase agreements use a tri-party clearing agent or bank. A custodian bank or clearing organization acts as an intermediary between the two parties to the repurchase agreement. The tri-party agent is responsible for the administration of the collateral, including the determination of the amount and form of collateral required to be maintained at any given time (based on the market value of the collateral and the contractual requirements for quantity and type of collateral). Both parties to the repurchase agreement must have cash and collateral accounts at the same tri-party agent. The tri-party agent will ensure that collateral pledged is sufficient and meets eligibility requirements, and all parties agree to use collateral prices supplied by the tri-party agent. A wider range of financial instruments for delivery is permitted based on different types of securities prescribed in the agreement. Common collateral eligibility criteria include asset type, issuer, currency, domicile, credit rating, maturity, issue size and average daily traded volume. Both the lender (transferee) and borrower (transferor) of cash enter into these transactions to avoid the administrative burden of bilateral repurchase agreements. Additionally, because the collateral is being held by a third party, counterparty risk is reduced.

**Hold-in-custody**

A hold-in-custody repurchase agreement is characterized by the “repo party” retaining control of the securities and by serving throughout the transaction not only as principal to the transfer but also as the “reverse repo party’s” custodial agent.
9.4 **Differences between a securities lending transaction and a repurchase agreement**

Although similar economically, securities lending transactions and repurchase agreements have some basic differences. The legal, regulatory and tax implications relevant to these transactions also vary in different markets. The table below highlights some of these basic differences:

<table>
<thead>
<tr>
<th>Securities lending transaction</th>
<th>Repurchase agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract</strong></td>
<td></td>
</tr>
<tr>
<td>In the US, the most widely used securities lending agreement is the Master Securities Loan Agreement, published by the Bond Market Association. For cross border transactions, the most widely used global master agreement is the Overseas Securities Lending Agreement (OSLA), organized under the English law.</td>
<td>The contract most often used in the US Treasury repo market is the Bond Market Association Master Repurchase agreement, documented under New York law. For cross border transactions, the most common master agreement used is the Global Master Repurchase Agreement, published jointly by the Bond Market Association and the International Securities Market Association (PSA-ISMA Agreement), often with a country-specific annex.</td>
</tr>
<tr>
<td><strong>Duration</strong></td>
<td></td>
</tr>
<tr>
<td>Securities lending transactions are predominantly made on an open basis, such that loans can be returned, recalled or reset either on demand or after an agreed notice period (generally between one and three days). In practice, maturity varies by the type of security lent. The typical length of a loan of equity securities is one to two months, compared to a few days when the securities loaned are fixed income.</td>
<td>Repurchase agreements are generally short-term agreements, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. Other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset.</td>
</tr>
<tr>
<td><strong>Collateral and transaction size</strong></td>
<td></td>
</tr>
<tr>
<td>Typically involve equity securities and are relatively much smaller in transaction size compared to repurchase agreements.</td>
<td>Typically involve fixed income securities (e.g., government and agency obligations) and are relatively much larger in transaction size compared to securities lending transactions.</td>
</tr>
</tbody>
</table>
Compensation to the lender is agreed to at the outset and is generally by fee when securities are received as collateral. When cash is taken as collateral, the securities lender invests the cash collateral and agrees to pay a rebate to the borrower on the value of cash received. The spread between the investment rate earned by the securities lender and the rebate rate agreed to with the borrower represents the lender’s revenue on the loaned securities.

The fee paid by a borrower is higher when there is a greater demand for the security to be borrowed and securities are provided as collateral. Alternatively, when cash is received as collateral, the rebate rate paid to the borrower is lower when the securities borrowed are in high demand or non-readily-obtainable in the marketplace.

The lending or repo rate is reflective of prevailing money market conditions. Repurchase agreements involving generic government securities define the benchmark yield curve in most markets, with collateral of lesser quality commanding higher rates.

Margin

Lenders typically require margin in addition to the value of the assets loaned to the borrower. Margin may be applied as an increase in the collateral required relative to the value of cash or securities lent (initial margin) or as a reduction in the valuation of the collateral taken (haircut). In principle, the amount of margin may depend on the quality, liquidity and price volatility of the securities loaned, the term of the loan or the frequency with which collateral will be revalued and margin calls made, and the creditworthiness of the counterparty.

In cash-driven transactions, the cash investor in a financing trade will usually take margin if it is more creditworthy than the borrower. In the securities-driven market, the securities lender usually takes margin, especially if it is more creditworthy than the borrower.

9.5 Determining when a securities lending transaction or repurchase agreement should be accounted for as a secured borrowing

When the FASB developed the derecognition model for transfers of financial assets, it believed that if judged only by the criteria in ASC 860-10-40-5(a) (i.e., legal isolation) and 40-5(b) (i.e., right to pledge or exchange), financial assets transferred under typical securities lending transactions and repurchase agreements would be derecognized because the transferred financial assets, which generally consist of securities that are readily obtainable in the market, are both isolated from the transferor and the transferee can – and typically does – obtain their benefits by selling or pledging them.

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68 In addition to the factors discussed in the table above, other factors that may affect the amount of compensation received in a securities lending transaction or repurchase agreement include:

- The creditworthiness of the borrower (although this tends to affect the level of collateral required rather than the lender’s remuneration)
- The tax status of the lender (particularly if the borrower will gain from a tax arbitrage strategy)
However, the FASB believes that effective control over the financial assets still exists in typical securities lending transactions and repurchase agreements. Consequently, ASC 860-10-40-5(c)(1) was added so that an agreement that both entities and obligates the transferor to repurchase or redeem them before their maturity results in the transferor maintaining effective control over the transferred financial assets.

9.5.1 Effective control through both a right and an obligation

Excerpt from Accounting Standards Codification

**860-10-40-24**

An agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor’s effective control over those assets as described in paragraph ASC 860-10-40-5(c)(1), if all of the following conditions are met:

a. The financial assets to be repurchased or redeemed are the same or substantially the same as those transferred. To be substantially the same, the financial asset that was transferred and the financial asset that is to be repurchased or redeemed need to have all of the following characteristics:

1. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which circumstance the guarantor and the terms of the guarantee must be the same)
2. Identical form and type so as to provide the same risks and rights
3. The same maturity (or in the circumstance of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)
4. Identical contractual interest rates
5. Similar assets as collateral
6. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved. Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Bond Market Association and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by the Bond Market Association.

See paragraph 860-10-55-35 for implementation guidance related to these conditions.

b. [Subparagraph superseded by Accounting Standards Update 2011-03]^[69]\n
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into contemporaneously with, or in contemplation of the transfer.

The FASB based its decisions about agreements that maintain effective control over transferred financial assets in part on practices that prevail in the repurchase agreement and securities lending markets. Concerns of market participants about risk of default by the parties to the contract, rights at law in the event of default, and credit risk of transferred financial assets, among other factors, have led to several contractual features intended to ensure that the transferors indeed maintain effective control.

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^[69] EY note: Refer to section 12.2 for information regarding the effective date and transition provisions of ASU 2011-03 and Appendix A (section A.2) for background information leading to the issuance of ASU 2011-03 and the requirements of ASC 860-10-40-24(b) prior to its amendment.
The following flowchart illustrates the steps to determine whether conditions described in ASC 860-10-40-5(c)(1):

An entity should first evaluate whether the transferred financial assets are readily obtainable in the marketplace. If the financial assets are not readily obtainable the repurchase agreement or securities lending transactions would generally be accounted for as a secured borrowing because the transferee’s ability to freely pledge or exchange the assets is effectively constrained (ASC 860-10-40-5(b)). See Chapter 4, Criteria for a sale – Right to pledge or exchange, for additional information.

![Flowchart Illustrating Steps to Determine Whether Conditions Described in ASC 860-10-40-5(c)(1)]

Note: The transfer is accounted for as a sale only if all other derecognition criteria (i.e., ASC 860-10-40-5(a) and 40-5(b)) have been met. Also consider the guidance on the accounting for “repurchase financings” in ASC 860-10-40-44 (see section 9.7).

### 9.5.1.1  Financial assets that are the same or substantially the same

ASC 860-10-40-24 clarifies that to maintain effective control the securities to be repurchased or redeemed must be the same or substantially the same as those transferred. The following criteria should be met in order to conclude that securities are substantially the same.

**Excerpt from Accounting Standards Codification**

860-10-55-35

- The same primary obligor (see paragraph 860-10-40-24(a)(1)). The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

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70 ASC 860 reiterated the guidance regarding whether securities are substantially the same that was originally included in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments (codified under ASC 860-10-55-35).
b. Identical form and type (see paragraph 860-10-40-24(a)(2)). The following exchanges would not meet this criterion:

1. GNMA I securities for GNMA II securities\(^{1}\)

2. Loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary in form and type)


c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield) (see paragraph 860-10-40-24(a)(3)). The exchange of a fast-pay GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a slow-pay GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

d. Similar assets as collateral (see paragraph 860-10-40-24(a)(5)). Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages, to meet this characteristic.

9.5.1.1.1

**Dollar rolls**

The term dollar roll covers a variety of transactions that involve an agreement to transfer a mortgage pass-through security in exchange for cash, generally at some future date. Some dollar rolls are similar to futures contracts traded on organized exchanges, while others are similar to financing transactions.

While the term dollar roll is used generically, there are at least two different types of dollar roll transactions.

- **Rolling transaction** – This type of transaction is a commitment to deliver a security at a future date. Typically, delivery of the security is not taken at any time. Rather, the entity’s strategy is to keep “rolling” these transactions, thereby earning a trading spread from the price differential of transactions scheduled to settle in different months. The price difference between months is known as the “drop.”

  In a rolling transaction, the buyer is able to invest the funds that otherwise would have been required to settle the trade. In rolling transactions no transfer of securities occurs. The only transfer that takes place is a money transfer representing the price differential discussed above.

- **Dollar-roll repurchase agreement** – This type is more akin to a repurchase agreement and is used as a cost-effective source of financing. An entity transfers a specific mortgage pass-through security held in inventory (i.e., on its balance sheet) in exchange for payment today and simultaneously agrees to repurchase the same or similar mortgage pass-through security at a specified date in the future.

  A dollar roll is analogous to a repurchase agreement, but there are important differences: (1) the party borrowing the securities in a dollar roll does not have to return the same securities but can instead return those that are “substantially similar” and (2) the original owner gives up principal and interest to the temporary holder of the securities (assuming record dates are passed during the period of the roll).\(^{2}\)

\(^{1}\) EY note: GNMA I securities represent a pool of mortgages issued by one issuer, all with the same interest rate and issued within a three month period. This is a basic pass-through security. GNMA II securities are also pass-through securities, except that the collateral can have a range of interest rates and can include mortgages issued by more than one issuer.

\(^{2}\) In a repurchase agreement, payments are made to the original owner (i.e., the transferor by the transferee in lieu of principal and interest payments). See footnote 65 for additional information.
Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement. Dollar-roll transactions should be evaluated to determine (1) whether they should be accounted for as financings or as separate sales and repurchases and (2) if considered separate sales and repurchases, how changes in the value of the underlying security should be recognized (i.e., whether the underlying security should be marked to market). ASC 860-10-55-58 through 55-60 address these questions and provide guidance.

**Excerpt from Accounting Standards Codification**

860-10-55

55-58 Whether paragraph 860-10-40-5(c) precludes sale accounting for a dollar-roll transaction depends on the facts and circumstances. Paragraph 860-10-40-24 states the conditions under which an agreement that both entities and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains the transferor’s effective control over those assets as described in paragraph 860-10-40-5(c)(1). The condition in paragraph 860-10-40-24(a) requires that the financial assets to be repurchased or redeemed are the same or substantially the same as those transferred. Paragraph 860-10-40-24(a) describes six characteristics that must all exist for a transfer to meet the substantially-the-same requirement. Paragraph 860-10-40-24(a)(6) requires (as one of those six characteristics) that the financial asset that was transferred and the financial asset that is to be repurchased or redeemed have the same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

55-59 For transfers of existing securities under a dollar-roll repurchase agreement, the transferee must be committed to return substantially-the-same securities to the transferor, which would indicate that the transferor has maintained effective control. In a transfer of existing securities under a dollar-roll repurchase agreement, if the transferee is committed to return substantially-the-same securities to the transferor but that transferee’s securities at the time of the transfer were to-be-announced securities, the transferor would not be precluded from accounting for the transfer as a secured borrowing. The transferor is only required to obtain a commitment from the transferee to return substantially-the-same securities and is not required to determine that the transferee holds the securities that it has committed to return. Therefore, the financial asset to be returned may be a to-be-announced asset at the time of the transfer because the transferor would have no way of knowing whether the transferee held the security to be returned.

55-60 As illustrated by the following, whether a GNMA roll[^73] is accounted for as a secured borrowing or a sale affects the evaluation of the forward contract embedded in the securities subject to the agreement:

a. Types 1-3 of dollar rolls would qualify for secured borrowing treatment if the redemption of securities on substantially the same terms is assured (see paragraph 860-10-40-24). In that circumstance, the forward contracts embedded in the Types 1-3 securities are outside the scope of Topic 815 because of the scope exception provided in paragraph 815-10-15-63 for derivative instruments that serve as impediments to sale accounting.

[^73]: EY note: The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed securities, frequently those issued by the GNMA. There are four basic types of transactions:

a. Type 1: Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo)

b. Type 2: Fixed coupon dollar reverse repurchase agreements (dollar repo)

c. Type 3: Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)

d. Type 4: Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist.
b. Type 2 and 3 securities that involve repurchase of other than substantially-the same securities are considered sales of securities and forward contracts. The forward contract would need to be evaluated under Subtopic 815-10 because it has terms that would generally meet the definition of a derivative instrument. If the dollar-roll repurchase agreement is accounted for as a sale under this Subtopic, Subtopic 815-10 provides guidance on the subsequent accounting for the forward contract.

9.5.1.2 Agreement to repurchase (redeem) before maturity, at a fixed or determinable price

ASC 860 does not specifically define the term “before maturity.” Generally, a transferor’s agreement to repurchase a transferred financial asset would not be considered a repurchase or redemption before maturity if, because of the timing of the redemption, the transferor would be unable to sell the financial asset again before its maturity (i.e., the period until maturity is so short that the typical settlement is a net cash payment). As a result, the criterion in ASC 860-10-40-24(c) is not met when the term of the repurchase arrangement extends to the maturity date of the transferred financial asset. In addition, the repurchase price for the transferred financial asset must be explicitly stated or determinable based on the terms of the contract. For example, an arrangement to repurchase the transferred financial asset at fair value to be determined at some future date would not meet the criterion because the purchase price is neither fixed nor determinable.

9.5.1.3 Agreement is entered into contemporaneously with, or in contemplation of, the transfer of financial assets

A transferor may maintain effective control over transferred financial assets if either of the following two conditions is met:

a. The agreement to repurchase or redeem the financial assets is executed concurrent with the transfer of financial assets

b. The two agreements are executed in contemplation of one another

The transfer of financial assets and the agreement to repurchase the transferred financial assets would be considered to be executed in contemplation of one another if the transactions are contractually contingent on one another. For example, if the pricing and performance of either agreement are contingent on the terms and execution of the other agreement, the two agreements may be considered contractually contingent. Contractual contingencies may be either explicit (e.g., pursuant to a written agreement) or implicit.

9.6 Accounting for securities lending transactions and repurchase agreements

If the conditions for sale accounting are met, a securities lending transaction or repurchase agreement should be accounted for as follows:

- The transferor should derecognize the transferred securities and recognize as proceeds the cash received and the forward repurchase commitment.

In a securities lending transaction (or similar arrangement), ASC 860-30-25-8 requires that any cash\(^{74}\) or securities received as collateral for securities loaned be recognized as an asset by the securities lender (transferor) as long as the securities received as collateral can be sold or repledged,

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\(^{74}\) Any investments made with cash received as collateral should be recognized, even if made by agents or in pools with other securities lenders, along with the obligation to return the cash.
regardless of whether the transaction is accounted for as a sale or a secured borrowing.\textsuperscript{75} The securities lender should also recognize as a liability the obligation to return the cash or securities received as collateral. See sections 9.2 and 9.2.2 for guidance on determining the securities lender in a securities lending transaction.

- The transferee should recognize both the securities received from the transferor (as purchased) and the forward resale commitment and derecognize the cash paid to the transferor.

The forward repurchase and resale commitments should be evaluated under ASC 815, Derivatives and Hedging, to determine if they meet the criteria to be accounted for as a derivative under that literature.

Repurchase agreements that extend to the maturity of the transferred financial assets and dollar repurchase agreements or other transactions in which the asset to be repurchased is not substantially the same as that originally transferred are common examples of transactions that would be accounted for as sales transactions.

However, most securities lending transactions and repurchase agreements result in the securities lender (transferor) maintaining effective control over the transferred financial assets pursuant to ASC 860-10-40-24, resulting in the transferor’s accounting as a secured borrowing.

See Chapter 8, Secured borrowings and collateral, for additional guidance on accounting for secured borrowings and collateral.

### 9.6.1 Examples illustrating accounting for securities lending transactions

<table>
<thead>
<tr>
<th>Illustration 9-1: Transfer of securities accounted for as a secured borrowing in exchange for cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A (transferor) lends a mortgage-backed security (MBS) with a fair value of $1,000 to Dealer B (transferee). Dealer B provides Bank A cash collateral of $1,020 for its obligation to return the MBS in ninety days. Bank A will pay to Dealer B a rebate of 2%, which represents interest on the cash received from Dealer B. Bank A invests the cash received from Dealer B in a money market instrument earning a return of 7%. Dealer B initially holds the MBS and then subsequently sells the MBS to its customer, Insurance Company C, for cash of $1,000. Assume that the transfer of MBS securities is accounted for as a secured borrowing because the requirements of ASC 860-10-40-24 are met.</td>
</tr>
</tbody>
</table>

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending transaction. Additionally, the fair value of the security is assumed not to change during the term of the transaction.

**Journal entries for the transferor (Bank A as securities lender)**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 1,020</td>
</tr>
<tr>
<td>Payable under securities loan agreement</td>
<td>$ 1,020</td>
</tr>
</tbody>
</table>

**Note:** To record the receipt of cash

\textsuperscript{75} ASC 860-10-55-50 states that to the extent that the collateral received by the securities lender consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or repledge, a securities lending transaction does not satisfy the sale conditions and is accounted for as a loan of securities by the transferor to the transferee.
MBS pledged to transferee $1,000
MBS $1,000

Note: To reclassify loaned securities that the securities borrower (transferee) has the right to pledge or exchange

Money market instrument $1,020
Cash $1,020

Note: To record investment of cash received from Dealer B – securities borrower (transferee)

At conclusion:
Cash $1,027
Interest revenue $7
Money market instrument 1,020

Note: To record results of investment of cash in money market instrument

MBS $1,000
MBS pledged to transferee $1,000

Note: To record return of MBS from Dealer B – securities borrower (transferee)

Payable under securities loan agreement $1,020
Interest expense (rebate) 2
Cash $1,022

Note: To record return of cash plus interest

Journal entries for the transferee (Dealer B as securities borrower)

At inception:
Receivable under securities loan agreement $1,020
Cash $1,020

Note: To record transfer of cash

Upon sale of the collateral:
Cash $1,000
Obligation to return MBS borrowed from transferor $1,000

Note: To record sale of collateral (MBS) to Insurance Company C and obligation to return MBS (it no longer holds) to Bank A (transferor)76

At conclusion:
MBS $1,000
Cash $1,000

Note: To record purchase of substantially the same MBS in the open market for return to transferor

76 Obligations to return to the transferor financial assets borrowed and then sold have sometimes been effectively recognized as part of a liability for securities sold but not yet purchased. ASC 860 does not require any change in that practice (see ASC 860–30–25–10).
Bank A lends a mortgage backed security (MBS) with a fair value of $1,000 to Dealer B. Dealer B provides Bank A with a US Treasury security that has a fair value of $1,020 as collateral for its obligation to return the MBS in ninety days. In addition, Dealer B will pay Bank A a $5 fee for the security lending arrangement at its conclusion. Both Bank A and Dealer B are permitted by contract and custom to pledge or sell the respective securities they hold during the term of the lending arrangement. Assume that the transaction qualifies for secured borrowing treatment because the requirements of ASC 860-10-40-24 have been met.

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending transaction. Additionally, the fair value of the security is assumed not to change during the term of the transaction.

### Journal entries for the transferor (Bank A as securities lender)

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasury securities</td>
<td>$ 1,020</td>
</tr>
<tr>
<td>Payable under securities loan agreements</td>
<td>$ 1,020</td>
</tr>
<tr>
<td>Note: To record the receipt of securities collateral from Dealer B(^77) that Bank A could pledge or exchange</td>
<td></td>
</tr>
<tr>
<td>MBS Securities pledged as collateral</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>MBS Securities</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Note: To reclassify loaned securities that Dealer B has the right to sell or repledge</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 5</td>
</tr>
<tr>
<td>MBS Securities</td>
<td>1,000</td>
</tr>
<tr>
<td>Securities lending fees</td>
<td>$ 5</td>
</tr>
<tr>
<td>MBS Securities pledged as collateral</td>
<td>1,000</td>
</tr>
<tr>
<td>Note: To record receipt of lending fee and return of loaned security from Dealer B</td>
<td></td>
</tr>
</tbody>
</table>

\(^77\) In a securities lending transaction, the transferor of securities being loaned must recognize securities received as collateral on its balance sheet irrespective of whether the transfer is accounted for as a sale or a secured borrowing provided that the transferor is permitted to sell or repledge such securities. This treatment is no different than how a transferor would account for cash received as collateral (ASC 860-30-25-B).
Payable under securities loan agreements $ 1,020
US Treasury securities $ 1,020

Note: To record return of securities collateral to Dealer B

Journal entries for the transferee (Dealer B as securities borrower)

At inception:
No entry.

At conclusion:
Security borrowing fees $ 5
Cash $ 5

Note: To record return of borrowed securities and payment of fee to Bank A

9.6.2 Examples illustrating accounting for repurchase agreements

Illustration 9-3: Repurchase agreement as a collateralized borrowing

Bank A holds a security that will mature in three years with a fair value of $1,000 and a coupon rate of 7%. It enters into a repurchase agreement with Dealer B to transfer the security for $980 and to repurchase the identical security from Dealer B in one year for $1,019. Dealer B has the right to pledge or exchange the acquired security but does not choose to do so. At the end of the year, Dealer B returns the identical security to Bank A in exchange for a cash payment of $1,019.

Additional assumptions and accounting analysis:

This transaction results in Bank A maintaining effective control over the security transferred because it is entitled and obligated to repurchase the security before its maturity and all of the requirements of ASC 860-10-40-24 have been met. Therefore, the transfer subject to the repurchase agreement is treated as a secured borrowing and not a sale. Because Dealer B has the right to pledge or exchange the security, Bank A must reclassify the transferred security on its balance sheet to securities pledged. Although Dealer B is able to pledge or sell the security it receives in the transaction, Dealer B is not required by ASC 860 to record the security received or a liability to return it unless it sells the security or Bank A defaults.

Note: For simplicity, this example does not address the accounting for any periodic principal and interest or dividend payments made by the issuer of the securities subject to the securities lending agreement. Also, the effects of changes in the fair value of the security during the one-year term of the transaction are not considered in this example.

78 At inception of the arrangement, Dealer B is not required to recognize the borrowed securities on its balance sheet. The obligation to return the securities is only recorded if the securities are sold by Dealer B or Bank A defaults under the agreement. The security held as collateral by Dealer B is disclosed in the notes accompanying the financial statements.
## Seller-Borrower (transferor) perspective – Bank A

<table>
<thead>
<tr>
<th></th>
<th>Before transfer</th>
<th>During term</th>
<th>At conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000</td>
<td>$2,980</td>
<td>$1,961</td>
</tr>
<tr>
<td>Securities</td>
<td>$1,000</td>
<td>–</td>
<td>$1,000</td>
</tr>
<tr>
<td>Securities pledged as collateral (1)</td>
<td>–</td>
<td>1,000</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$3,000</td>
<td>$3,980</td>
<td>$2,961</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payable under repurchase agreement</td>
<td>–</td>
<td>$980</td>
<td>–</td>
</tr>
<tr>
<td>Equity</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$2,961</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$3,000</td>
<td>$3,980</td>
<td>$2,961</td>
</tr>
</tbody>
</table>

(1) Regardless of whether Bank A (seller-borrower) has the right to redeem the collateral on short notice or a right to substitute collateral (common in repurchase agreements with no set maturity), this reclassification entry is required.

(2) Represents the reporting period’s beginning cash balance ($2,000), plus the net cash payment received on the initial transfer ($980). Although not shown in the example for purposes of simplicity, Bank A’s (seller-borrower’s) income statement and balance sheet would also reflect the interest income from the security and investment of the cash proceeds as well as interest expense on an accrual basis on its liability under the repurchase agreement.

(3) Represents cash balance at the conclusion of the transaction which includes the beginning cash balance ($2,980) less the repurchase agreement final settlement payment ($1,019).

## Buyer-Lender (transferee) perspective – Dealer B

<table>
<thead>
<tr>
<th></th>
<th>Before transfer</th>
<th>During term</th>
<th>At conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,980</td>
<td>$1,000</td>
<td>$2,019</td>
</tr>
<tr>
<td>Receivable under repurchase agreement</td>
<td>–</td>
<td>$980</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$1,980</td>
<td>$1,980</td>
<td>$2,019</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Obligation to return collateral (4)</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Equity</td>
<td>$1,980</td>
<td>$1,980</td>
<td>$2,019</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$1,980</td>
<td>$1,980</td>
<td>$2,019</td>
</tr>
</tbody>
</table>

(4) The entry by Dealer B (buyer-lender) to record the collateral held is not required, unless Dealer B sells the collateral or Bank A defaults. If the collateral received (i.e., the security) is sold, Dealer B records the proceeds and an obligation to return the collateral. If repledged, it only records the obligation under the new borrowing related to the pledge. If Bank A defaults, then Dealer B would recognize the collateral as its asset (unless it had already been sold), and it would derecognize any recorded obligation to return it.

(5) Represents cash balance at the conclusion of the transaction which includes the beginning cash balance ($1,000) plus the repurchase agreement final settlement payment ($1,019). Although not shown in the example for purposes of simplicity, Dealer B’s income statement and balance sheet also would reflect on an accrual basis interest earned on the funds loaned to Bank A.
Illustration 9-4: Repurchase agreement accounted for as a sale transaction

Consider the same fact pattern as described in Illustration 9-3, except that the security to be returned at the maturity of the repurchase agreement is not required to be substantially the same as that tendered at the initiation of the transaction. Rather, any similar security that has the same market yield and fair value may be returned. Provided the transaction meets the criteria of ASC 860-10-40-5(a) and 40-5(b) for sale accounting, the seller-borrower would account for the repurchase agreement as a sale of the financial assets and a forward purchase commitment, and the buyer-lender would account for the agreement as a purchase of the financial assets and a forward sale commitment.

Assume that Bank A’s carrying amount (cost) and the fair value of the security transferred is $1,000, the cash proceeds are $980 and the agreed repurchase amount is $1,019. For simplicity, it is assumed that there is no unrealized gain or loss on the transferred security, the effects of changes in the fair value of the security during the one-year term of the transaction and interest earned on the cash proceeds are not considered in this example. In addition, assume that the fair value of the security at the end of one year equals the amount suggested by the transaction ($1,039). The fair value of the forward contract is assumed to be $20, which represents an asset for Bank A and a liability for Dealer B. Thus, Bank A has no gain or loss on the sale.

**Seller-Borrower (transferor) perspective – Bank A**

<table>
<thead>
<tr>
<th></th>
<th>Before transfer</th>
<th>During term</th>
<th>At conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$2,000</td>
<td>$2,980</td>
<td>$1,961</td>
</tr>
<tr>
<td>Securities</td>
<td>1,000</td>
<td>–</td>
<td>1,039</td>
</tr>
<tr>
<td>Forward contract to repurchase securities</td>
<td>–</td>
<td>20</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$3,000</td>
<td>3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Equity</td>
<td>3,000</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

The use of a debt security as collateral for an obligation can be considered consistent with an entity’s assertion that it has the intent and ability to hold the security to maturity provided the transaction is not considered a sale under ASC 860-10-40-5 and the entity intends and expects to satisfy the obligation without surrendering the debt security (ASC 320-10-25-18). In other words, a held-to-maturity security can be subject to a repurchase agreement or a securities lending agreement as long as the transaction is accounted for as a secured borrowing and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral (ASC 320-10-25-18(e)). However, if the transaction were considered a sale and the held-to-maturity security is transferred for a reason other than those specified in ASC 320-10-25-6, ASC 320-10-25-9 and ASC 320-10-25-14, the transfer would taint the held-to-maturity portfolio.

The forward contract would appear to meet the definition of a derivative to which the provisions of ASC 815, *Derivatives and Hedging*, would be applicable.
Buyer-Lender (transferee) perspective – Dealer B

<table>
<thead>
<tr>
<th>Assets</th>
<th>Before transfer</th>
<th>During term</th>
<th>At conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 1,980</td>
<td>$ 1,000</td>
<td>$ 2,019</td>
</tr>
<tr>
<td>Securities</td>
<td>$ -</td>
<td>$ 1,000</td>
<td>$ -</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 1,980</td>
<td>$ 2,000</td>
<td>$ 2,019</td>
</tr>
</tbody>
</table>

| Liabilities and equity    |                 |             |               |
| Forward contract to sell security | $ -       | $ 20        | $ -           |
| Equity                    | $ 1,980         | $ 1,980     | $ 2,019       |
| Total liabilities and equity | $ 1,980       | $ 2,000     | $ 2,019       |

During the term of the repurchase agreement, Dealer B presumably would measure the security at fair value and account for the forward contract pursuant to ASC 815.

9.7 Repurchase financings

In February 2008, the FASB issued guidance primarily codified in ASC 860-10-40-42 through 40-47 concerning when a transferor and transferee should account separately for an initial transfer of a financial asset and a related repurchase financing.

The guidance presumes that an initial transfer of a financial asset and a repurchase financing with the same counterparty are part of the same arrangement (linked transactions), including if the two transactions were not executed at the same time but were in contemplation of, or contingent upon, one another.

Determining whether the two transactions should be linked is important because if they are, the assets transferred by the initial transferor would likely fail the legal isolation requirements of ASC 860-10-40-5(a), and the transferor would continue to recognize the assets transferred. The implication for the transferee of the financial assets is that the transaction is initially recognized as a forward purchase transaction.

9.7.1 Overview of repurchase financings

A repurchase financing is defined by the FASB as a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer.

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79 As used in this definition, the term consolidated affiliate is an entity whose assets and liabilities are included with those of the counterparty in the consolidated, combined or other financial statements being presented. The term consolidated affiliate is used in a narrower context than the term affiliate in ASC 850, Related Party Disclosures. The Board clarified this point to emphasize that whether a transferor has isolated the transferred assets can depend on which financial statements are being presented. For example, a financial asset transfer to a third party by a wholly-owned subsidiary combined with a repurchase agreement between the subsidiary’s parent and the same third party could result in a linked transaction at the consolidated level of the parent, but not at the subsidiary level.
The following diagram from ASC 860-10-55-17A is an example of an initial transfer of a financial asset and a subsequent repurchase financing that should be analyzed under the provisions of ASC 860.

The diagram above depicts the following three transfers of a financial asset that typically occur in the transactions covered by the scope of the guidance for repurchase financings beginning in ASC 860-10-40-42:

a. Initial transfer – the initial transferor transfers a financial asset to the initial transferee in return for cash.

b. Execution of a repurchase agreement – the initial transferee enters into a financing arrangement with the initial transferor. The initial transferee transfers the previously transferred financial asset to the initial transferor as collateral for the financing. The initial transferee receives cash from the initial transferor. As part of the financing arrangement, the initial transferee is obligated to repurchase the financial asset (or substantially the same financial asset\(^{80}\)) at a fixed price within a prescribed period.

c. Settlement of the repurchase financing – the initial transferee makes the required payment to the initial transferor under the terms of the repurchase financing. Upon receipt of payment, the initial transferor returns the transferred asset (or substantially the same asset) to the initial transferee.

ASC 860-10-55-17C clarifies that whether or not the parties agree to net settle steps (a) and (b) should not affect whether the transactions are within the scope of the guidance for repurchase financings beginning in ASC 860-10-40-42. However, the ability to net settle the transactions is a factor to consider in determining whether the two transactions meet all of the provisions in ASC 860-10-40-42 through 40-44.

### 9.7.2 Evaluating linkage

A transferor and transferee do not separately account for a transfer of a financial asset and a related repurchase financing unless both of the following conditions are met:

- The two transactions have a valid and distinct business or economic purpose for being entered into separately.
- The repurchase financing does not result in the initial transferor regaining control over the financial asset.

The FASB developed specific criteria to help apply the above requirements and distinguish between those transactions that should be considered together (linked) and those that should not (unlinked).

The criteria are set forth in ASC 860-10-40-44 and are discussed further in the section below.

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\(^{80}\) See ASC 860-10-40-24 and ASC 860-10-55-35 for additional guidance on determining whether financial assets are substantially the same.
9.7.2.1 Criteria for determining whether transactions should be linked

Pursuant to ASC 860-10-40-44, an initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another will be considered linked unless all of the following criteria are met at the inception of the transaction:

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>860-10-40-44</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. The initial transfer and the repurchase financing are not contractually contingent on one another. Even if no contractual relationship exists, the pricing and performance of either the initial transfer or the repurchase financing shall not be dependent on the terms and execution of the other transaction.</td>
</tr>
</tbody>
</table>

A repurchase financing that occurs months after the initial transfer of the financial asset would still be included in the scope of ASC 860 if the transaction were described in the original agreement. However, the absence of a specific reference to the second contract in the original contract does not automatically cause the transactions to satisfy this criterion if the terms or actions of the counterparties indicate that an understanding existed at the time of the original contract. That is, implied commitments also need to be considered because they demonstrate that the counterparties intend to engage in a series of related transactions.

**Excerpt from Accounting Standards Codification**

<table>
<thead>
<tr>
<th>860-10-40-44</th>
</tr>
</thead>
<tbody>
<tr>
<td>b. The repurchase financing provides the initial transferor with recourse to the initial transferee upon default. That recourse must expose the initial transferor to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. The initial transferee’s agreement to repurchase the previously transferred financial asset (or substantially the same asset) is for a fixed price and not fair value.</td>
</tr>
</tbody>
</table>

An initial transferor that does not have recourse to the initial transferee in the event of default remains subject to all the downside market risk of the security because the only remedy upon the transferee’s default is to liquidate the security. Additionally, if the repurchase agreement is at fair value (i.e., the repurchase financing obligates the transferee to buy back the security at fair value), the market risk associated with the transferred security is presumed to reside with the initial transferor during the duration of the repurchase financing. If the market risk remains with the initial transferor, the initial transferor is considered to control the asset because it has obtained more than a trivial benefit from the second transaction.

To meet the risk transfer criterion of ASC 860-10-40-44(b), the initial transferor should receive a sufficient level of recourse to expose it to the credit risk of the initial transferee, or its affiliates, and not solely to the market risk of the transferred financial asset. Standard repurchase agreements do not limit the parties’ rights to recourse. Consequently, an arrangement that provides the initial transferor with recourse to the transferee, but only up to a specified percentage of losses (e.g., a specified percentage of the principal amount of the repurchase agreement), may not meet the risk transfer criterion of ASC 860-10-40-44(b).

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81 Excerpt from paragraph A12, Background Information and Basis for Conclusions, FASB Staff Position FAS 140-3: Accounting for Transfers of Financial Assets and Repurchase Financing Transactions
Therefore, if any limits exist on the initial transferor’s recourse to the initial transferee, management will need to prepare and maintain contemporaneous documentation to demonstrate how the recourse provisions of the repurchase financing “sufficiently” expose the transferor to the credit risk of the transferee. In general, the more limited the initial transferor’s recourse to the initial transferee (i.e., the less substantive the recourse) the more likely the transactions will be considered linked for failure to transfer market risk.

Excerpt from Accounting Standards Codification

860-10-40-44

c. The financial asset subject to the initial transfer and repurchase financing is readily obtainable in the marketplace. In addition, the initial transfer of a financial asset and the repurchase financing are executed at market rates. This criterion may not be circumvented by embedding off-market terms in a separate transaction contemplated with the initial transfer or the repurchase financing.

If the initial transferor provides the initial transferee with a lower rate on the repurchase financing than would otherwise be obtained in an active market, or if the initial transferor requires specific knowledge of the asset to provide a better rate on the repurchase financing, the initial transferee is economically compelled to execute the repurchase financing with the initial transferor. In these circumstances, the initial transferor effectively maintains control over the transferred financial asset because the initial transferee is unlikely to execute the repurchase financing with anyone other than the initial transferor. Therefore, to provide evidence that the initial transferor does not require specific knowledge of the asset (i.e., to conclude that the asset is not unique), the financial asset must be readily obtainable in the marketplace.

While deliberating the accounting requirements for repurchase financings, the FASB contemplated limiting this criterion to “assets that have a quoted price in an active market (Level 1 inputs as defined in ASC 820, Fair Value Measurement).” However, the FASB decided not to adopt that definition and, instead, to use the concept of “readily obtainable,” which is an existing concept in ASC 860.

Judgment must be exercised in evaluating whether a particular security or asset class is “readily obtainable” since the term is not specifically defined in ASC 860. For example, US Treasury securities and other debt instruments issued by government agencies, and debt securities of large public companies that are actively traded, would likely be “readily obtainable” securities. Conversely, a debt security collateralized by a single commercial real estate property, or a beneficial interest in an entity that owns subprime loans, may not be readily obtainable.

Current market conditions also must be considered when assessing new transactions as certain financial instruments that may historically have been considered readily obtainable may no longer be readily obtainable (e.g., certain vintages of subprime mortgage backed securities). However, the criteria outlined in ASC 860-10-40-42 to 40-44 are assessed only at the inception of the transaction and should not be reevaluated during the life of the repurchase financing.
Excerpt from Accounting Standards Codification

860-10-40-44

d. The financial asset and repurchase agreement are not coterminous (the maturity of the repurchase financing must be before the maturity of the financial asset).

In order to satisfy this requirement to account for transactions separately, the repurchase financing must mature before the maturity date of the underlying financial asset. The initial transferor is presumed to effectively maintain control over the transferred financial asset if the financial asset and the repurchase agreement have the same term. The reason for this conclusion is that the asset would mature at the same time it would have to be returned to the initial transferee and the transferor has the ability to use the asset without the possibility of ever being required to return the asset to the borrower.\(^\text{82}\) Therefore, a repurchase-to-maturity transaction would not meet this criterion for separate accounting.

9.7.2.2 Evaluating the accounting for linked and unlinked transactions

Pursuant to ASC 860-10-40-45, if the transactions meet all of the criteria for separate accounting specified in ASC 860-10-40-43 through 40-44, the initial transfer is accounted for separately from the repurchase financing. That is, the initial transfer is evaluated to determine if it meets the requirements for sale accounting under ASC 860-10-40-5 without taking into consideration the repurchase financing. The initial transferor and initial transferee should then analyze the repurchase financing as a repurchase agreement under ASC 860-10-40-24.

If the transactions do not meet all of the criteria specified above, ASC 860-10-40-46 states that the initial transfer and repurchase financing should be evaluated as a linked transaction, which should be evaluated to determine whether it meets the requirements for sale accounting under ASC 860. When deliberating the accounting for repurchase financings, the FASB noted that the linked transaction would generally preclude a conclusion that the initial transfer should be accounted for as a sale by the transferor and a purchase by the transferee because of the difficulty in obtaining legal opinions to support the legal isolation criteria in ASC 860-10-40-5(a). A linked transaction that does not meet the requirements for sale accounting should be accounted for based on the economics of the combined transactions, which is consistent with a forward contract.

ASC 815, *Derivatives and Hedging*, should be used to evaluate whether the linked transaction must be accounted for as a derivative and remeasured at fair value. If the linked transaction does not represent a derivative as defined in ASC 815,\(^\text{83}\) other accounting literature should be considered, including the guidance on contingencies (ASC 450). The accounting for transactions that do not meet the definition of a derivative are beyond the scope of this publication.

\(^{82}\) ASC 860-10-55-51 describes how to determine whether the repurchase agreement matures before the maturity of the asset.\(^{83}\) The guidance in ASC 815-10-35-5 may be applicable if the financial asset associated with the linked transaction is a security that will be accounted for under ASC 320.
Accounting for repurchase financings may have a significant effect on the assets and liabilities reported on the balance sheet (i.e., recognition or derecognition of the underlying asset versus recognizing a payable or receivable associated with the repurchase financing forward contract) and presentation of revenues and expenses on the statement of operations (i.e., investment or trading gains or losses rather than interest income and expense). For affected entities that do not primarily hold financial assets and liabilities reported at fair value, linked transactions may also result in earnings volatility if the forward contract is required to be remeasured at fair value.

The accounting for an initial transfer of a financial asset and a repurchase financing should be evaluated at the inception of the transaction (see ASC 860-10-40-44) and should not be reevaluated after inception. Therefore, if at a later date the initial transferee enters into a financing arrangement with the initial transferor for the same transferred financial assets, the initial accounting conclusions regarding linkage should not be reevaluated (provided the criteria were properly evaluated). However, the requirements in ASC 860-20-25-8 still apply and thus the initial accounting conclusions for a transfer of financial assets should be reassessed if at a later date there is a change in law or other circumstances that may result in the transferor regaining or relinquishing control of the previously transferred assets.

Companies can reduce the likelihood of inadvertently creating a linked transaction by requiring all transactions to be entered into at arm’s length (evidenced by the existence of an active market and published prices or rates) and by requiring that a separate, independent operating unit select the counterparty for a repurchase financing.

When the transactions involve financial assets for which fair value must be estimated using Level 2 or 3 inputs (as described in ASC 820, Fair Value Measurement) and, therefore, the assets may not be readily obtainable, it is even more important that the company maintain contemporaneous documentation that supports management’s assertion that the initial transfer was not contingent on the subsequent financing. These internal control considerations are particularly important given the presumption in ASC 860-10-40-44 that an initial transfer of a financial asset and a repurchase financing are part of the same arrangement.

9.7.2.3 Forward contracts associated with linked transactions

A standard (unlinketed) repurchase agreement is economically equivalent to a cash transaction (sale of a security) combined with a forward contract (forward purchase). The cash transaction results in the transfer of money to the borrower in exchange for legal transfer of the security to the lender, while the forward contract results in the repayment of the loan and return of the collateral to the borrower. The difference between the forward price (the repurchase agreement final settlement amount) and the spot price (the repurchase agreement principal amount outstanding as of the measurement date) is the interest on the financing (assuming a finance rate is not separately stated). The settlement date of the forward contract is the maturity date of the financing.

The economics of a linked repurchase financing are similar to the unlinked repurchase agreement described above. The major difference is that in a linked repurchase financing forward contract, the spot price represents the fair value of the underlying security rather than the principal amount outstanding on the measurement date. The valuation considerations for a forward contract associated with a linked repurchase financing are discussed further in the illustrative example below.
When determining the accounting for the forward contract, the first step is to determine whether the forward is a derivative under ASC 815, Derivatives and Hedging. ASC 815-10-15-83 defines a derivative instrument as a financial instrument or other contract that:

a. Has (1) one or more underlying and (2) one or more notional amounts or payment provisions, or both

b. Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

c. Has terms that require or permit net settlement, can readily be settled net by a means outside the contract, or provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement (i.e., the asset is readily convertible to cash)

The first two conditions described above generally will be met for the forward resulting from the accounting for linked transactions. The third component of the definition, however, will require further analysis. In most circumstances, the repurchase agreement will not provide for net settlement. Accordingly, the asset to be delivered at the maturity of the repurchase agreement must be examined to determine if it is “readily convertible into cash.” For example, assume a forward contract associated with a linked transaction involves the transfer of US Treasury Notes. Because US Treasury Notes are readily convertible to cash, the securities put the recipient in a position not substantially different from net settlement if the contract itself does not contain net settlement provisions. Therefore, the forward contract would be accounted for as a derivative pursuant to ASC 815 and remeasured at fair value each reporting period, with changes in fair value recognized in earnings.

The concept of “readily convertible to cash” is not necessarily the same as “readily obtainable” in the marketplace as that concept is used in ASC 860. The concept of “readily convertible to cash” is not clearly defined in ASC 815. While there are no bright lines with respect to this determination, many practitioners start with a presumption that if 90% or more of the current fair value of a financial asset can be realized within three to seven days, that financial asset is “readily convertible to cash.” Determining whether a forward contract represents a derivative under ASC 815 will require management to forecast whether the underlying asset will be readily convertible to cash at the maturity of the transaction. Additionally, the evaluation of whether the asset is readily convertible into cash must be reassessed throughout the life of the forward contract and, as a result, the forward contract may meet the definition of a derivative in one period and not in another period. The concept of “readily convertible to cash,” as interpreted in ASC 815-10-15-119 to 15-139 is discussed in detail in our Financial Reporting Developments publication, Derivative instruments and hedging activities.

84 Refer to ASC 815-10-15-99 for additional information regarding the net settlement criterion.
9.7.3 Repurchase financing decision tree

Was the repurchase financing entered into contemporaneously with, or in contemplation of, the initial transfer? (ASC 860-10-40-44(a))

Yes

No

Are the initial transfer and the repurchase financing contractually contingent on one another? (ASC 860-10-40-44(a))

Yes

No

Does the repurchase financing provide the initial transferor with recourse to the initial transferee upon default and is the repurchase agreement for a fixed price and not fair value? (ASC 860-10-40-44(b))

Is the financial asset subject to the initial transfer and repurchase financing readily obtainable in the marketplace? (ASC 860-10-40-44(c))

Yes

No

Are the financial assets and repurchase agreement coterminous? (ASC 860-10-40-44(d))

Yes

No

Initial transfer and the repurchase financing are evaluated as a linked transaction. (ASC 860-10-40-46)

Repurchase agreement is accounted for separately from the initial transfer. (ASC 860-10-40-45) Consider relevant paragraphs of ASC 860-10-40-24 when accounting for the repurchase agreement.

Does the linked transaction meet the sale accounting criteria under ASC 860-10-40-5? (see Note 2 below)

Yes

No

Account for the initial transfer as a sale under ASC 860 (see Note 2 below).

Transferor does not derecognize the transferred securities and the transferee has an off balance sheet transaction. Both counterparties evaluate whether the repo forward contract is a derivative to be remeasured at fair value under ASC 815 (see Note 1 below).

Note 1: A fundamental objective of ASC 860 is symmetrical accounting between the transferor and the transferee (see paragraph 227 of Background Information and Basis for Conclusions to Statement 140). Consequently, the same transaction cannot be a borrowing-lending arrangement to the transferor and a purchase-sale transaction to the transferee.

Note 2: In practice, a linked transaction generally would not meet the sale accounting criteria of ASC 860 as it would likely fail the legal isolation requirement of ASC 860-10-40-5(a). However, determining whether a transaction results in derecognition of the transferred financial assets depends on facts and circumstances and requires a careful analysis of all forms of the transferor’s continuing involvement, including consideration of the bankruptcy laws applicable to the jurisdictions in which the transfer occurred.
9.7.4 Accounting for a “linked transaction” – an illustrative example

The following example illustrates the accounting under ASC 860 for a transfer of a financial asset that is linked with a repurchase agreement.

**Illustration 9-5:**

On 1 January 2009, Hedge Fund ABC purchases agency mortgage-backed securities (the MBS Securities) from Bank XYZ for $700. The MBS Securities are “readily obtainable” in the market. Simultaneously, Hedge Fund ABC enters into a repurchase agreement with Bank XYZ whereby Hedge Fund ABC borrows $665 and pledges all of the MBS Securities as collateral. Bank XYZ has full recourse to Hedge Fund ABC if the latter defaults on its obligations under the repurchase agreement. The finance rate on the repurchase agreement was negotiated in conjunction with the initial sale of the MBS Securities. Moreover, the finance rate is determined to be below market rates quoted by third party dealers for loans collateralized by similar securities. Additional assumptions include:

**MBS Securities:**

<table>
<thead>
<tr>
<th>Maturity date</th>
<th>31 December 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par value</td>
<td>$1,000</td>
</tr>
<tr>
<td>Annual coupon/interest rate</td>
<td>80 (8% per annum, paid semi-annually)</td>
</tr>
<tr>
<td>Bank XYZ cost basis</td>
<td>995</td>
</tr>
<tr>
<td>Fair value at repo inception</td>
<td>700</td>
</tr>
<tr>
<td>Fair value at 31 December 2009</td>
<td>880</td>
</tr>
<tr>
<td>Fair value at 30 June 2010</td>
<td>950</td>
</tr>
</tbody>
</table>

**Repurchase agreement:**

<table>
<thead>
<tr>
<th>Expiration date</th>
<th>30 June 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial principal amount</td>
<td>$665</td>
</tr>
<tr>
<td>Final settlement amount</td>
<td>665 (Excludes the finance interest amount)</td>
</tr>
<tr>
<td>Annual repurchase agreement cost / interest rate</td>
<td>34 (5.11% per annum, paid semi-annually)</td>
</tr>
</tbody>
</table>

**Accounting analysis:** Since the contracts were entered into contemporaneously, the requirements of ASC 860-10-40-44 must be analyzed:

- ¶40-44(a) criterion – Failed. The finance rate negotiated by the two parties was contingent upon the sale of the MBS Securities.
- ¶40-44(b) criterion – Passed. Bank XYZ has full recourse to Hedge Fund ABC, and not solely the market value of the MBS Securities returned as collateral. Additionally, the repurchase price is fixed.
- ¶40-44(c) criterion – Failed. The finance rate is below market rates. Since Hedge Fund ABC is effectively compelled to execute the repurchase agreement with Bank XYZ because of the lower rate available from Bank XYZ, the latter is considered to effectively maintain control over the transferred financial asset.
- ¶40-44(d) criterion – Passed. The repurchase agreement expires 2½ years before the securities mature.

Because at least one of the above criteria was not met, the transactions are linked pursuant to ASC 860-10-40-44. In these particular facts and circumstances, legal counsel is unable to conclude that Bank XYZ has legally isolated the transferred securities until the end of the repurchase agreement term (i.e., the transfer fails criterion ASC 860-10-40-5(a)).
The repurchase financing decision tree in section 9.7.3 provides a schematic of the accounting analysis required for repurchase financings.

**Forward contract**:\(^{85}\)

In our example, we assume that the underlying MBS Securities are “readily convertible to cash” and, therefore, the forward contract is a derivative as defined in ASC 815 and must be remeasured at fair value. The approximate value of the forward contract is computed as the sum of:

- The difference between the fair value of the MBS Securities at the reporting date and the repurchase agreement final settlement amount,\(^{86}\) and

- The difference between the MBS Securities coupon payments and the repo financing cost for the time remaining to the maturity of the repo.

For instance, at 31 December 2009, the value of the forward obligation recorded by Bank XYZ is $\text{\$238} = [($880 - $665) + ($40 - $17)]. For simplicity, the present value considerations associated with the fair value of the forward contract are ignored in our calculation. In reality, estimating the fair value of a forward contract typically involves a “cost of carry” approach in which the present value of expected payments at the contract’s maturity are adjusted by the present value of the expected benefits or costs realized during the holding period, including counterparty credit risk, as may be appropriate.

In a standard repurchase agreement, the lender typically receives collateral (in the form of securities) from the borrower that exceeds the amount of cash loaned. In practice, the overcollateralization amount (which is akin to a purchase deposit or margin in a repurchase financing evaluated as a linked transaction) generally would vary between two percent and five percent of the principal amount loaned pursuant to the repurchase agreement. During the term of the financing arrangement, amounts borrowed or securities pledged as collateral are adjusted between the counterparties to maintain the overcollateralization provision stipulated in the repurchase agreement.

In this example, the initial overcollateralization amount is $35, which is computed as the difference between the price paid by Hedge Fund ABC for the MBS Securities ($700) and the repurchase agreement initial principal amount ($665). For simplicity, this example ignores the adjustments to the overcollateralization amount\(^{87}\) that typically would be required in subsequent periods in response to changes in the fair value of the collateral (securities) pledged.

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\(^{85}\) While legally the parties did not enter into a forward contract, because the initial transfer is not accounted for as a sale, affected entities are required to account for the initial transfer and the repurchase financing based on the economics of the combined transactions, which are generally consistent with a forward contract.

\(^{86}\) When the repurchase agreement final settlement amount exceeds the fair value of the transferred assets on the measurement date, the difference represents a liability for the buyer of the forward contract and an asset for the seller.

\(^{87}\) Any change in the overcollateralization requirement will have a direct and offsetting effect on the repurchase agreement final settlement amount.
### Seller (initial transferor) perspective – Bank XYZ

<table>
<thead>
<tr>
<th></th>
<th>Before transfer</th>
<th>31 December 2009</th>
<th>30 June 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 2,000</td>
<td>$ 2,069&lt;sup&gt;88&lt;/sup&gt;</td>
<td>$ 2,751&lt;sup&gt;89&lt;/sup&gt;</td>
</tr>
<tr>
<td>Securities – available-for-sale</td>
<td>700</td>
<td>880</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$ 2,700</td>
<td>$ 2,949</td>
<td>$ 2,751</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward contract to sell securities</td>
<td>–</td>
<td>$ 238</td>
<td>–</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>(295)</td>
<td>180&lt;sup&gt;90&lt;/sup&gt;</td>
<td>–</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,995</td>
<td>2,531</td>
<td>2,751</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>$ 2,700</td>
<td>$ 2,711</td>
<td>$ 2,751</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$ 2,700</td>
<td>$ 2,949</td>
<td>$ 2,751</td>
</tr>
</tbody>
</table>

**Note:** Although Bank XYZ must account for the linked transaction as a financing through 30 June 2010, the unrealized loss captured in other comprehensive income becomes an other-than-temporary impairment (OTTI) at the inception of the transactions with Hedge Fund ABC (i.e., the $295 unrealized loss is recognized through the income statement). The OTTI is triggered because Bank XYZ has now demonstrated that it intends to sell the MBS Securities before recovery of the impairment. Bank XYZ could reduce future volatility in reported earnings by designating the forward contract at inception of the linked transaction as a cash flow hedge of the probable sale of the MBS Securities (assuming the relevant criteria in ASC 815 are satisfied). Thereafter, any subsequent changes in the forward contract’s fair value would be recorded in other comprehensive income as an offset to the unrealized gain or loss attributed to the hedged financial asset that is also included in other comprehensive income. Refer to ASC 815-20-55-116 for further guidance.

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<sup>88</sup> Represents the reporting period’s beginning cash balance, plus annual coupon payment received on the MBS Securities owned, plus the net cash payment received on the initial transfer and repurchase agreement and the repurchase agreement interest payment, less the MBS Securities interest coupon owed to Hedge Fund ABC or ($2,000+$80+($700-$665)+$34-$80) = $2,069.

<sup>89</sup> Represents 31 December 2009 cash balance plus the repurchase agreement final settlement payment plus semi-annual securities coupon and semi-annual repurchase agreement interest payment, less the semi-annual MBS Securities coupon payment due Hedge Fund ABC or ($2,069+$665+$40+$17-$40) = $2,751.

<sup>90</sup> Represents 31 December 2009 cash balance plus the repurchase agreement final settlement payment plus semi-annual securities coupon and semi-annual repurchase agreement interest payment, less the semi-annual MBS Securities coupon payment due Hedge Fund ABC or ($2,069+$665+$40+$17-$40) = $2,751.

At 31 December 2009, the balance reported in other comprehensive income represents the difference between the fair value of the MBS Securities and Bank XYZ’s new basis following the other-than-temporary impairment recognized at the inception of the transactions or $880-$700 = $180.
Wash sale transactions

Wash sales are transactions in which an entity sells a security and then repurchases the same or substantially the same security at some future date. Though the period of time between sale and reacquisition varies, it is often very short (less than 30 days). Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the FASB concluded that the transferor does not maintain effective control over the transferred financial assets during the period they have been sold. As a result, wash sales are accounted for as sales under ASC 860.

Sale accounting may not be appropriate if there is a concurrent agreement (whether explicit or implicit) to repurchase the security (see also ASC 860-10-55-5-7 for implementation guidance about accounting for wash sales).

Certain wash sales are disregarded for purposes of computing income taxes in the United States. The US Internal Revenue Service (IRS) defines a wash sale to have occurred when stock or securities are sold or traded at a loss and within 30 days before or after the sale any of the following have been met:

- Substantially identical stock or securities are bought back by the seller.
- Substantially identical stock or securities are acquired back in a fully taxable trade by the original seller.
- A contract or option to buy substantially identical stock or securities is entered into by the original seller.

The IRS has concluded that losses from sales or trades of stock or securities in a wash sale are not deductible for tax purposes.

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91 Represents the reporting period’s beginning cash balance, less the net cash payment made to Bank XYZ on the initial transfer and repurchase agreement, plus the net interest payment received from Bank XYZ at the end of the period representing the difference between the coupon earned on the MBS Securities and the repurchase agreement interest or ($1,000+($665-$700)+($80-$34)) = $1,011.

92 Represents 31 December 2009 cash balance, plus the repurchase agreement final settlement payment, plus the semi-annual MBS Securities coupon received from Bank XYZ, less the semi-annual repurchase agreement interest payment to Bank XYZ or ($1,011+$665+$40-$17)=$369.

93 Internal Revenue Service publication 550
10  

Securitizations

10.1  Overview

Determining the accounting for transfers of financial assets can be especially challenging for securitization transactions due to the variety and complexity of structures that have evolved over time. This chapter discusses the fundamentals of the securitization process and describes the application of ASC 860 to some common securitization structures.

Before considering the derecognition criteria, a transferor should first determine whether the securitization entity should be consolidated by the transferor (which obviates the need to determine whether the transferred financial assets can be derecognized). Refer to our Financial Reporting Developments publication, Consolidation of variable interest entities, for further details.

10.2  Securitizations

Generally, securitization is a structured finance process in which the cash flows and related risks (e.g., credit, prepayment, liquidity) of a pool of financial assets are redistributed by the issuance of new securities backed by the same asset or pool of financial assets. The securities are commonly referred to as asset-backed securities and the investors holding such asset-backed securities are referred to as beneficial interest holders.

There are several stages to a securitization transaction. The following schematic shows the phases of a securitization transaction and the primary activities that take place in each phase. The schematic is not intended to be all inclusive, and the actual activities and market participants may vary depending on the nature of the assets being securitized and the structure of the securitization vehicle.
### 10.2.1 Pooling and transfer of assets

#### Transaction initiation stage
- Entity considers financing alternatives (including securitizations options) and evaluates the advantages and disadvantages of each alternative.
- If securitization is chosen as the final alternative, an available financial asset pool is identified for securitization.

#### Transaction structuring stage
- The transaction is structured and due diligence is performed, including credit rating agency review.
- Legal documents are drafted, new legal entities are created, and a trustee is appointed for the securitization entity.
- The asset-backed securities (beneficial interests) to be issued by the securitization entity are marketed and initially priced.

#### Transaction closing stage
- Pooled financial assets are transferred to a securitization entity (either in a “single-step” or “two-step” transaction).
- Ratings are provided by the credit rating agencies.
- Asset-backed securities (beneficial interests) are sold to investors by the securitization entity to finance the purchase of the asset pool.

#### Post-transaction closing stage
- Servicer collects payments received from the asset pool held by the securitization entity and remits to trustee; addresses delinquencies/defaults; and reports collateral data to trustee.
- Trustee calculates cash flow and distributes funds to beneficial interest holders; enforces provisions of governing documents.
- Administrator prepares books and records and tax returns.

In a typical asset-backed securitization, the transferor (also known as the sponsor) bundles together financial assets such as credit card receivables or mortgage loans from a number of its customers (or borrowers) and transfers those assets to an entity formed for the specific purpose of funding the assets. A special-purpose entity (SPE, also referred to as a bankruptcy-remote entity or BRE) generally is required to ensure that the transferred financial assets are put beyond the reach of the transferor and its creditors even in the event of the transferor’s bankruptcy or receivership. In most structures, a second transfer of the assets to a trust occurs (another SPE, broadly referred to as a securitization entity or issuer) and the trust issues the asset-backed securities. As discussed in Chapter 3, Criteria for a sale – Legal isolation, the combination of the two transfers (a two-step transaction) typically is necessary to accomplish legal isolation.

### 10.2.2 Issuance of asset-backed securities (beneficial interests)

To purchase the assets from the transferor, the securitization entity issues securities to investors either through a private offering or a public offering. As explained in ASC 860-10-05-8, these securities may comprise either a single class having equity characteristics or multiple classes of interest, some having debt characteristics and others having equity characteristics. Credit rating agencies rate the securities in order to provide an external assessment and help the potential beneficial interest holders make a more informed investment decision. Credit rating agencies determine their ratings of asset-backed securities based on the anticipated performance of the underlying collateral pool (including the probability of default) and any credit enhancements provided through securitization.
10.2.3 Static and managed pools

Securitizations either involve “static” assets or “managed” pools of assets. In transactions involving static assets, the assets are held by the securitization entity until repaid by the original obligor. In transactions involving managed pools of assets, the assets may be actively traded by the appointed asset manager of the trust to maximize returns and manage exposure to credit, interest and other market risks. In securitizations with static assets, typically the transferor will assemble the underlying assets, help structure the securities and work with the underwriters to sell the securities to investors. In transactions involving managed assets, an asset manager (which may also be the transferor) performs some or all of those same functions.

10.2.4 Fixed and floating interest rates

The securities are issued with either a fixed interest rate or a floating rate. The coupon (interest rate) on fixed rate securities is determined at the time of issuance. In contrast to fixed rate securities, the rates on floating rate securities are periodically adjusted up or down according to a designated index (e.g., the London Interbank Offered Rate (LIBOR)). The floating rate typically reflects an additional fixed margin over the specified index (e.g., LIBOR plus 150 bps) to cover other risks associated with the securities (e.g., credit, liquidity).

10.2.5 Credit enhancement

Unlike most conventional unsecured corporate bonds, securities created in a securitization transaction are credit enhanced – that is, the credit quality of certain securities issued is increased above that of the underlying asset pool. The credit enhancement increases the likelihood that the investors will receive cash flows to which they are entitled, which causes the majority of the issued securities to have a higher credit rating than the assets transferred to the securitization vehicle. Credit enhancement does not transform poor credit assets into good credit investments; instead, credit enhancement helps to offset potential losses. Some securitizations use external credit enhancement such as letters of credit or surety bonds provided by a third party for a fee that provide guarantees or partial guarantees of the assets within the securitization vehicle. Performance guarantees or recourse arrangements may also be provided by the transferor, although this may prevent the transferor from achieving the legal isolation required for sale accounting or derecognition (refer to Chapter 3, Criteria for a sale – Legal isolation).

Some other common mechanisms used to provide credit protection or credit enhancement in a securitization transaction include overcollateralization, excess spread, cash collateral and credit tranching. Each of these mechanisms is discussed further below.

10.2.6 Overcollateralization

Overcollateralization can be achieved by transferring excess collateral to a securitization entity thereby providing protection to investors against credit losses. The excess collateral represents the amount by which the face value of the transferred assets (e.g., underlying pool of mortgage loans) exceeds the par value of the securities issued by the securitization entity. Thus, even if some of the payments from the underlying assets are late or default, investors will not experience losses until defaults on the underlying assets exceed the amount of overcollateralization provided.

10.2.7 Excess spread

Another way to enhance credit protection through securitization structures is through the issuance of securities (beneficial interests) that pay a lower interest rate than the underlying assets that serve as collateral. Excess spread represents the difference between the coupon on the underlying assets (collateral) less the cost of financing those assets (e.g., the coupon payable on securities (beneficial interests) issued by the securitization entity, charge-offs, servicing costs and any other trust related costs). The excess spread can be used to absorb collateral losses or to build overcollateralization to its target level.
10.2.8 Cash collateral account

A cash collateral account is a segregated account established by a securitization entity (trust), funded (generally by the transferor) at the time securities (investor certificates or beneficial interests) are issued. These accounts may consist of cash or short-term, highly-rated investments and can be used to make up for cash-flow shortfalls. For example, these funds can be used to cover interest or principal on the investor certificates or trust expenses (e.g., servicing fees) when cash flows from underlying assets are insufficient and when the excess spread, if any, falls below zero.

10.2.9 Credit tranching

Credit enhancement can also be provided through the process of credit tranching (also referred to as tranching of cash flows). The securities issued by securitization entities are often split into discrete tranches (e.g., classes of securities) based on degree of subordination. Each tranche has a different level of credit protection or risk exposure. There is generally a senior class of securities and one or more junior subordinated classes that function as protective layers for the senior class. The senior classes have first claim on the cash flow that the securitization entity receives from the assets it holds, and the more junior classes only start receiving payments after the more senior classes have been repaid.

Because of the cascading effect between classes, this arrangement is often referred to as a cash flow waterfall. In the event that the underlying asset pool is insufficient to make payments on all of the securities (e.g., when loans within a portfolio default), the loss is absorbed first by the most subordinated tranche, and the upper-level tranches remain unaffected until the losses exceed the entire amount of the subordinated tranches. The senior securities are typically AAA rated, signifying a lower risk, while the lower-credit quality subordinated classes receive a lower credit rating, signifying a higher risk.

The most junior class (often called the equity class or residual interest) is most exposed to risk. Often the equity class is held by the transferor as part of the proceeds in a transfer of assets accounted for as a sale and receives no periodic payment, but only the residual cash flow (if any) after all the other classes have been paid.

There may also be one or more special class of securities (or beneficial interests) that absorbs the underlying assets’ early repayment risk. This is often the case in which the underlying assets are residential mortgage loans. By passing any early repayments on to this class, the other investors in the securitization entity have more predictable cash flow investments. These concepts are discussed further in the section below in which we address common securitization transactions, including real estate mortgage investment conduits.

10.2.10 Repayment of beneficial interests

Most beneficial interests in securitizations are amortized – that is, the principal amount borrowed is repaid gradually over the specified term of the beneficial interest (e.g., asset-backed securities), rather than in one lump sum at the maturity of the beneficial interest. Fully amortizing beneficial interests are generally collateralized by fully amortizing assets such as home equity loans or auto loans. Prepayment uncertainty is a key concern with fully amortizing asset-backed securities. The possible rate of prepayment varies widely with the type of underlying asset pool and other factors. Consequently, many prepayment models have been developed in an attempt to estimate future prepayment activity. The PSA Prepayment Model[^94] is a well-known example.

[^94]: The PSA Prepayment Model is a prepayment model developed by the Bond Market Association, formerly known as the Public Securities Association, or PSA, that assumes increasing prepayment rates for the first 30 months of the lifetime and constant prepayment rates thereafter.
A controlled amortization structure is a method of providing investors with a more predictable repayment schedule, even though the underlying assets may be non-amortizing. After a predetermined “revolving” period (common in securitizations of credit card receivables), during which only interest payments are made, these securitizations are designed to return principal to investors in a series of defined periodic payments. An early amortization event is the risk of the beneficial interest being retired early (e.g., due to an unplanned liquidation of assets generally due to the deterioration in the credit quality of the underlying assets). However, certain structures return the principal to investors in a single payment referred to as a “bullet” payment.

Securitizations are often structured as a series of “sequential pay” bonds, which are paid off in a sequential manner based on maturity. This means that the first tranche (or most senior asset-backed security class), which may have a one-year average life, will receive all principal payments until it is retired; then the second tranche begins to receive principal payments and so forth. Pro rata bond structures (or pass-through securitizations) pay each tranche a proportionate share of principal throughout the life of the security. Examples of pass-through securitizations include guaranteed mortgage securitizations such as those sponsored by the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

10.2.11 Servicing

Once the underlying assets (e.g., mortgage loans) are transferred to a securitization trust and the securitization process is complete, the assets are serviced in accordance with the servicing agreement for the trust. The servicing agreement contains provisions specifying the allocation and distribution of asset proceeds and losses to the beneficial interest holders. It also contains provisions regarding how the assets are to be serviced and servicing requirements under special circumstances. A securitization trust may appoint a separate master servicer, primary or sub-servicer and a special servicer.

The servicer can significantly affect the cash flows to the investors because it controls the collection policy, which influences the proceeds collected on the assets. Any cash remaining after expenses and payments due to beneficial interest holders is usually accumulated, at least in part, in a reserve or spread account, with any remaining cash returned to those holding the residual equity interest (generally, the transferor/seller).

See Chapter 7, Servicing of financial assets, for additional information on the different types and roles of servicers of financial assets and for guidance on accounting for servicing rights.

10.2.12 Advantages and disadvantages of securitization

Securitizations allow an entity to raise capital, restructure debt or otherwise adjust its finances and represent an alternative to more traditional corporate finance options such as a loan, bond issue or issuance of equity such as common stock. Listed below are some of the typical advantages and disadvantages of securitizations.

Advantages

Reduces funding costs — An entity may be able to reduce its funding costs through the securitization process. This is accomplished by legally isolating the pool of assets from the transferor and through credit enhancement (e.g., third-party guarantees, subordination). In other words, an entity rated “BBB” may be able to borrow at “AAA” rates through securitization structures. This represents the primary motive to securitize cash flows and can significantly reduce the cost of funding.
Lower capital requirements – Due to legal, regulatory or other reasons, some entities such as banks and insurance companies have a limit on the amount of leverage (borrowing) they may incur without raising additional equity capital. By securitizing some of their assets and structuring the transfer of financial assets to achieve sale accounting, these entities may be able to reduce the amount of required capital on their balance sheets while maintaining a portion of the “earnings power” of the transferred assets.

Transfer risks – Securitization makes it possible to transfer all or some portion of risk (e.g., credit, liquidity, prepayment, reinvestment, asset concentration) from an entity that does not want to bear it to those that are willing to do so.

Liquidity and locking in profits – Securitization transactions allow an entity to immediately monetize and reinvest the future cash flows of assets that otherwise are not currently available. For example, mortgage originators have historically been in the business of profiting from the fees associated with loan origination and securitization, rather than bearing the long-term risk of the assets they have originated.

Disadvantages

Costs – Securitizations result in significant incremental costs due to legal fees, underwriting fees, credit rating fees and ongoing administrative costs.

Size limitations – Securitizations often require a large pool of assets in order to recover, through reduced funding costs, the incremental costs discussed above. Therefore, securitizations of small- and medium-size pools of assets may not be cost efficient.

Risks – Because a securitization is a structured transaction, investors typically demand that the issuer retain a residual or subordinated interest (e.g. residual tranche) in the transferred assets, which provides a form of credit protection to the investors. These retained interests expose the issuer to credit loss and prepayment risk and consequently reduce the overall credit quality of its retained investment portfolio. Additionally, if the underlying assets perform significantly worse than expected, or if the credit protection is not sufficient, the securitization process exposes the sponsor (the transferor) to reputational and legal risk.

10.3 Common types of securitization transactions

Securitizations can take many different forms depending on the financial assets being transferred, the objective of the transfer, and investor demands for certain type of securities or beneficial interests. Some of the common types of securitization transactions include:

- Guaranteed mortgage securitizations
- Transfers of receivables to a conduit entity that issues commercial paper (CP conduits)
- Securitizations with a reinvestment feature (revolving-period securitizations)
- CDOs (Cash, market value and synthetic CDOs)
- Real estate mortgage investment conduits (REMICs) and RE-REMICs

10.3.1 Guaranteed mortgage securitization

A guaranteed mortgage securitization (GMS) is a securitization of a mortgage loan or group of loans that includes a substantive third-party guarantee. Fannie Mae and Freddie Mac, two shareholder-owned, congressionally chartered corporations, are the largest providers of guarantees in this market.

Generally, in a GMS guaranteed by Fannie Mae or Freddie Mac (collectively, government-sponsored enterprises or GSEs), mortgage originators or purchasers of mortgages (e.g., commercial banks, credit unions) sell their mortgages to a GSE. The GSE in turn issues securities backed by those mortgages.
These securities represent an undivided ownership interest in the pool of mortgages and are generally referred to as “participation certificates,” or “pass-through securities.” The GSE also guarantees the beneficial interest holder payment of interest and principal on the underlying mortgages. This guarantee increases the value and liquidity of the participation certificates. The GSE will charge a management and guarantee fee for managing the underlying assets, issuing the participation certificates and guaranteeing payments on the participation certificates. The fee covers:

- Projected credit-related losses from borrower defaults over the life of the mortgages
- Administrative costs associated with underwriting, pooling and servicing the underlying mortgages, investor reporting, etc.
- The return on capital deployed to securitize and guarantee the underlying mortgages

The GSEs also serve as master servicer and generally have the unilateral right to remove the primary servicer (often the mortgage originator/transferor). The GSEs also establish the servicing standards that must be followed by the primary servicer.

The Government National Mortgage Association (Ginnie Mae) is another significant market participant. Ginnie Mae is a government-owned corporation within the Department of Housing and Urban Development whose securities are backed by the full faith and credit of the United States. Unlike Fannie Mae and Freddie Mac, which support the conventional (conforming mortgage loan) mortgage market, Ginnie Mae primarily supports the market for certain federally insured loans.

Specifically, Ginnie Mae guarantees the payment of principal and interest on securities that are based on and backed by pools of residential mortgages that are mainly insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. Ginnie Mae’s mission is similar to those of Fannie Mae and Freddie Mac (i.e., to work in the secondary mortgage markets and improve homeownership opportunities). However, in addition to differences in the types of mortgages that back the securities guaranteed by these entities, there are significant differences in the structure of their securitization programs. For example, consider the following excerpt from the Mortgage Bankers Association description of the Ginnie Mae MBS program:

“There is no trust holding the mortgages backing Ginnie Mae pass-through certificates. Rather, the Ginnie Mae MBS Program calls for the establishment of custodial pools [so called “virtual entities”], whereby the Issuer/Servicer conveys to Ginnie Mae all the rights, title and interest to the mortgages in the pool. Fannie Mae and Freddie Mac utilize trusts to pool and segregate assets [see Note 1] and they are the Trustee of the trusts, not an independent bank trust department. ...Ginnie Mae has the ability to legally isolate pools of mortgage loans without the use of a trust or other legal entity and to permit the issuance of pools of mortgage loans as securities through the US Federal Reserve’s book-entry system. Ginnie Mae itself does not issue any securities, but instead guarantees the Ginnie Mae mortgage backed security issued by banks, thrifts and mortgage bankers that participate in Ginnie Mae’s programs.”

Note 1: Federal charters grant Fannie Mae and Freddie Mac the ability to legally isolate pools of mortgage loans with the use of a trust or legal entity.\textsuperscript{[95]}

10.3.2 Commercial paper conduits

Transfers of receivables to conduits that issue commercial paper take many forms. These entities, whose sole purpose is to facilitate asset-backed financing, are referred to as commercial paper (CP) or asset-backed commercial paper conduits. Because trade receivables are non-interest bearing, they generally are purchased at a discount to their face amount and any collections in excess of those needed to pay the commercial paper holders is returned to the transferor as proceeds in the form of a subordinated interest (e.g., first-loss beneficial interest or a deferred purchase price) in the transferred receivable. Conduits are usually nominally capitalized, bankruptcy-remote special-purpose vehicles that are established by the manager/servicer and not the sponsoring bank or financial institution that transfers financial assets into the conduit.

A CP program is comprised of a conduit that issues commercial paper and uses the proceeds of such issuance primarily to obtain interests in various types of financial assets, either through asset purchases or secured lending transactions. The repayment of commercial paper issued by a conduit depends primarily on the cash collections received from the conduit’s underlying asset pool and also on the conduit’s ongoing ability to issue new commercial paper.

There are several types of mechanisms present in the typical commercial paper conduit to reduce risk for the commercial paper investors. Some of these protections include credit enhancements, liquidity support and commercial paper stop-issuance and wind-down triggers. To support liquidity in case cash collections of the conduit are not enough to redeem its commercial paper, liquidity providers are appointed to stand ready to buy the commercial paper issued by the conduit or purchase its assets so that the related proceeds can be used to repay the commercial paper.

The commercial paper issued by a typical CP conduit is short-term debt, generally limited to a tenor of no more than 270 days and issued on either an interest-bearing or discount basis. Generally, a CP conduit is exempt from the registration requirements of the Securities Act of 1933. The proceeds of CP issuance are primarily used to obtain interests in various types of asset classes including trade receivables, consumer debt receivables, auto and equipment loans and leases, and collateralized debt obligations.

CP programs are generally sponsored by banks or financial institutions to either finance a company’s financial assets (generally known as single-seller conduits) or to provide financing alternatives to the sponsor’s clients (generally known as multi-seller conduits). The multi-seller structure provides the flexibility to purchase a variety of financial assets from many different sellers.

10.3.3 Revolving-period securitization

The ASC Master Glossary defines revolving-period securitizations as “securitizations in which receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of receivables cash collections to purchase additional receivables from the transferor on prearranged terms.” Typically, such a structure is used for securitization of open-ended revolving loans (e.g., credit card receivables, revolving lines of credit, automobile dealer loans, and home equity lines of credit).

In a typical revolving-period securitization, a financial institution (the transferor or sponsor) accumulates a pool of receivables from revolving loan accounts (e.g., credit card debt) in its portfolio. The financial institution then transfers that pool of receivables either directly or indirectly (via a two-step transfer) to a

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96 To minimize losses resulting from a deteriorating asset portfolio or upon the occurrence of an event that threatens the conduit’s ability to repay maturing CP in full, CP programs are typically structured with mandatory CP stop-issuance or wind-down triggers. If triggers (e.g., based on level of default, liquidity, etc.) with respect to a specific transaction or the entire asset portfolio are breached, the conduit immediately ceases issuing new CP or begins liquidating its asset portfolio.
Securitizations

A securitization entity (e.g., a tax exempt special-purpose finance corporation or trust) in exchange for cash and a subordinated interest in that securitization entity. Typically, the transferor services the receivables for the securitization entity and receives a servicing fee as compensation. As explained in ASC 860-10-05-11, securitizations of credit card and other receivable portfolios usually involve a specified reinvestment period (usually 18 to 36 months), during which the trust will purchase additional credit card receivables generated by the selected accounts. The transferor’s beneficial interests in the receivables in the securitization entity will increase or decrease depending on the aggregate outstanding principal balances of the selected accounts. However, during the reinvestment period, the investors’ dollar investment remains constant because principal payments allocated to the investors’ interest are reinvested into additional credit card receivables.

**Excerpt from Accounting Standards Codification**

860-10-05-11

After the reinvestment period, a period of liquidation occurs during which the investors receive an allocated portion of principal payments relating to receivables in the trust. The liquidation method may vary depending on the terms of the agreement and may be a participation method (payout allocation rate may be fixed, preset, or variable) or a controlled amortization method (payout based on a predetermined schedule). Specific methods are as follows:

a. Fixed participation method
b. Floating participation method
c. Preset participation method.

**Master Glossary**

**Fixed participation method** – Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which all principal payments on the receivables in the trust are allocated to the investors based on their respective participation interests in the credit card receivables in the trust at the end of the reinvestment period.

**Floating participation method** – Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which principal payments allocated to the investors are based on the investors’ actual participation interests in the receivables in the trust each month. Each month, investors’ participation interests in the credit card receivables in the trust are redetermined for that month’s allocation of principal payments.

**Preset participation method** – Liquidation method used to allocate principal payments on receivables in a trust to investors. The preset participation method is similar to the fixed participation method except that the percentage used to determine the principal payments allocated to the investors is preset higher than the investors’ expected participation interests in the receivables in the trust at the end of the reinvestment period. This method results in a faster payout to the investors than the fixed participation method because a higher percentage of the principal payments are allocated to the investors.

Credit card and other revolving-period securitizations are typically structured as a master trust. Once a master trust is created, it can be used for multiple issuances from the same trust. A master trust can be thought of as a pool of receivables, to which, at times, new receivables are added so that more beneficial interests can be issued to third-party investors. Use of a master trust increases flexibility for the issuer and is cost effective from an administrative perspective as a separate trust is not created for each issuance.

10.3.4 Collateralized debt obligation

A collateralized debt obligation (CDO) is a securitization structure that involves a bankruptcy-remote special-purpose vehicle that issues multiple classes of beneficial interests backed by a pool of financial assets. The beneficial interests issued may be comprised of both debt and equity components. The collateral pool can be static or revolving. A revolving CDO will usually have an asset manager who will actively manage the financial assets of the CDO through reinvesting, hedging and perhaps a limited amount of trading, in return for fees that could be dependent on how effectively the asset manager is able to manage the assets and generate returns while minimizing losses. CDOs allow investors to choose beneficial interests suitable to their risk-reward profile and, in some cases, CDOs can be structured to meet specific customer appetite for risk.
Broadly, CDOs can be divided into three categories:

- Cash flow
- Market value
- Synthetic CDOs

In cash flow CDO structures, credit quality and performance of the underlying financial assets are of primary importance and market price fluctuations are of secondary importance. Financial assets in cash flow CDOs generally are not traded, but are held to maturity to generate cash flows for beneficial interest holders. The principal risk to collateral cash flows is credit risk (i.e., the possibility that the expected stream of cash flows will not be collected due to potential default in the underlying financial assets/collateral). Also, in cash flow CDO structures, the ratings of the securities issued by the CDO trust would depend upon the ability of the underlying collateral pool to generate sufficient cash flows to cover interest and principal payments.

In contrast to cash flow CDOs, market value CDO structures are rated based on market value over-collateralization. In such structures, market fluctuations (market risk) constitute the primary risk. This type of structure is not very common and is generally used for securitization of more volatile asset classes (e.g., equity securities and similar funds) that may be actually traded by the asset manager.

Synthetic CDOs, as the name suggests, synthetically provide exposure to a particular bond portfolio to the beneficial interest holders through use of credit default swaps (CDS). For example, the securitization entity may synthetically create exposure to the bonds of a particular issue by purchasing US Treasury securities and writing a CDS. The combination of the US Treasury securities and CDS replicates the economic characteristics of a bond of the entity whose credit risk underlies the CDS. In a Synthetic CDO transaction, the trust effectively sells credit protection on an underlying pool of assets and in return receives a fee (a guarantee premium) as compensation for bearing the credit risk. The trust then redistributes the credit risk to the note-holders and also passes through the premiums received from the protection buyers.

A variety of asset types can be included as a collateral pool in a CDO structure. For example:

- Collateralized Bond Obligations are securities backed by corporate bonds or emerging market debt.
- Collateralized Loan Obligations are securities backed by bank loans.
- Structured Finance CDOs are securities backed by commercial mortgage-backed securities, asset-backed securities, REIT debt or beneficial interests issued by other CDOs.
- Collateralized Synthetic Obligations are securities backed by debt securities and credit default swaps.
- Collateralized Fund Obligations are securities backed by investments in hedge funds or hedge fund units.

10.3.5 Real estate mortgage investment conduit (REMIC) and RE-REMICs

A real estate mortgage investment conduit (REMIC) is a multiple-class security vehicle designed to achieve preferred tax treatment for issuers and investors. Like other securitizations, interest and principal payments from the underlying financial assets (mortgage-related collateral in this case) are structured into tranches of separate securities. A REMIC securitization entity (REMIC trust) redistributes the cash flow from the underlying mortgage-related collateral to the holders of each tranche (or class) of securities. These classes are contractually distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, each class may have different coupon rates, average
lives and final maturities. REMIC trusts that meet certain conditions are subjected to special tax provisions, which exclude them from taxation at the trust level. Instead, only the distributions to investors are taxed. The largest issuers of REMIC securities are the government sponsored entities (i.e., Fannie Mae and Freddie Mac). However, some private institutions, including investment banks, other financial institutions and home builders also issue mortgage-backed securities (referred to as private-label REMICs).

10.3.5.1 REMIC classes

A REMIC may include any number of interest-paying classes, including a residual interest class. These classes can pay fixed-, floating- or zero-interest rates. In a typical REMIC structure, principal on senior classes is retired on a sequential basis. An investor in this senior class is paid interest calculated on the outstanding principal balance of the class; however, principal repayments to an investor typically do not begin until the previous class is retired or as otherwise described in the security’s prospectus.

The general characteristics of typical REMIC classes are described below.

**Sequential pay classes** – Sequential pay classes are also known as “Plain Vanilla” classes. In sequential pay structures, all principal amortization and prepayments allocable to the senior classes go to the shortest maturity, most senior class until it is fully retired; then principal payments are directed to the next shortest maturity class. This process continues until all classes are paid down. While principal is paying down on one class, remaining classes (except for classes representing residual interests) receive monthly interest payments at the coupon rate on their principal. The actual time that each class is outstanding, as well as the period that principal payments begin and end for each class, will vary based on actual prepayment experience.

**Planned amortization classes (PACs)** – PACs are designed to produce more stable cash flow by directing prepayments from the underlying mortgage-related collateral to other classes, called companion or support classes (discussed further in the following paragraphs). The investor typically receives principal payments in a predetermined time period based on a range of prepayment scenarios (the PAC “band”). PACs are designed to provide investors with both prepayment and extension risk protection. However, the payment schedule will be met only if the underlying mortgage-related collateral prepays at a rate within the range assumed for the structuring of the PAC. For example, if cash collections or repayments from the underlying mortgage-related collateral occurs slower than anticipated (i.e., below the lower range of the PAC band), the life of the PAC is extended; similarly, if the speed of repayment is faster than anticipated (above the upper range of the PAC band), the life of the PAC is shortened.

**Targeted amortization classes (TACs)** – TACs are classes that pay “targeted” principal payments based on a constant prepayment speed. As long as the underlying mortgage-related collateral does not prepay at a rate slower than the targeted constant prepayment speed, the payment schedule will be met. If prepayments are faster than the targeted prepayment speed, excess cash flow will be paid to support classes and the TAC will pay principal according to schedule. If prepayments are slower than anticipated, the average life of the TAC will extend because there will be insufficient funds available to meet the principal payment schedule. TACs are usually found in REMIC transactions that have PAC classes and may serve to absorb some of the cash flow variability directed away from PAC classes. Compared to PACs, TACs have greater cash flow uncertainty and greater extension risk.
Support or companion classes – Support or companion classes are designed to absorb the prepayment risk of the underlying mortgage-related collateral to provide more stable cash flows to other classes in the structure. By their nature, they have more volatile cash flows depending upon the volatility of the prepayment speeds of the underlying mortgage-related collateral. When prepayment speeds fluctuate, the average life of a support class can change dramatically. The average lives of support or companion classes are extended during periods of low prepayments and shortened during periods of accelerated prepayments. Principal cash flows are paid to any PAC, TAC or other scheduled class in a REMIC transaction before they are paid to support classes. Any excess principal cash flow is used to pay down the principal on the outstanding support class (classes). If no support class remains outstanding, then the principal cash flow is used to retire the outstanding PACs, TACs and scheduled classes in order of their stated priorities. On the other hand, when principal cash flow is slower than expected, support classes may not receive any principal during the period in which prepayments are low.

Accrual classes – Investors in accrual classes receive no cash flow from the security until certain other classes are paid off. Unlike other classes that pay interest each month, interest that would have been paid to the accrual class is added to its principal balance until the applicable prior classes have paid off. Over time the balance grows and the interest earned, but not paid, is calculated upon this increasing balance (i.e., interest compounds). Once the prior classes have been paid off, the accrual class becomes an interest-paying amortizing class that pays down like a sequential pay class.

Interest only and principal only classes (IO/PO) – REMIC structures can contain IO/PO classes in which each class receives a portion of the monthly principal or interest payments from the underlying mortgage-related collateral by “stripping apart” the principal and interest cash flow streams. The underlying mortgage-related collateral’s scheduled principal amortization and prepayments go to the principal only (PO) class. The interest cash flow goes to the interest only (IO) class.

The value of an IO class can fluctuate significantly due to changes in interest rates. An IO class not only faces the market risks associated with fixed rate securities, but also faces risk of early prepayment of the amount of the principal on the underlying collateral upon which the IO cash flows are based. For example, if all underlying mortgage loans held as collateral by a securitization entity were to prepay at a rate faster than originally anticipated, investors holding an IO beneficial interest in such assets would not only experience loss of anticipated income, they would also experience the likelihood of not recovering the initial investment. That scenario is likely in periods of declining interest rates when sales of real estate tend to rise and homeowners look to refinance their mortgages at cheaper rates.

During a rising interest rate environment, slower than expected prepayments generally are observed. In those instances, the cash flows to the IO class will increase, thereby increasing the yield to investors. Conversely, while early prepayments of underlying mortgage loans negatively affect the value of the IO class, such prepayments provide an enhancement to the yield of the PO class because investors receive the principal cash flows at an accelerated rate. However, if principal prepayments do not materialize as assumed at the time of investment (i.e., the prepayments are slower than anticipated), then the yield on the PO class would be less favorable.

Floating-rate and inverse floating-rate classes – A floating-rate class is structured so that the coupon rate payable to the investor adjusts periodically (usually monthly) by adding a certain spread to a benchmark index. In some cases, a cap is present that regulates the highest coupon the class can pay in its lifetime. As the name implies, an inverse floating-rate class is a security class with a coupon rate of interest that varies inversely with changes in specified interest rate levels or indexes (e.g., LIBOR).
10.3.5.2 RE-REMICs

In a typical RE-REMIC structure, the securities issued by a REMIC trust are backed by the securities of another REMIC. These transactions are sometimes referred to as “re-securitizations.” Operationally, the process begins with an investor transferring ownership of one or more REMIC issued securities to a special-purpose entity that inturn transfers the REMIC securities to a securitization trust. The trust then issues new “RE-REMIC” securities using the original REMIC securities as the underlying assets (rather than whole loans, for example). The new structure may contain securities issued by multiple underlying REMICs.

Similar to other securitization structures, a trustee is appointed to manage the operations of the new securitization trust. This trustee is responsible for receiving the cash distributions on the underlying securities and making the cash distributions to the holders of the RE-REMIC securities. In a simple RE-REMIC structure, as few as one senior and one subordinate class may exist. In that case, realized losses may be first allocated to the subordinated class and then to the senior class. Other structures may have multiple sequential classes and more complex interest and principal waterfalls. The RE-REMIC classes are rated by one or more rating agencies based upon their current assessment of the expected performance of the underlying mortgage-related assets in the original REMIC, as well as the payment priorities of the underlying REMIC and RE-REMIC structures.

Often the primary objective of the re-securitization process is to reduce the credit risk inherent in the underlying REMIC securities. For example, an entity may transfer a group of existing mortgage-backed securities to a newly created securitization trust and obtain most, if not all, of the senior beneficial interests issued by the securitization trust. Investors other than the transferor purchase some or all of the subordinated interests, thereby reducing the transferor’s overall credit exposure. These higher credit quality interests also receive more favorable regulatory capital treatment resulting in a lower capital charge. As a hypothetical example, a $50 million asset that required $1 million in capital at an “AAA” rating may require $17.5 million if downgraded to “BB-.” At “CCC,” the capital requirement might rise to 100%, or $50 million. In a RE-REMIC, 75% of the same asset may regain an “AAA” rating, requiring just $750 thousand in capital. The remaining one-quarter may require 100% capital, but the total capital requirement would fall to $13.25 million.

Another objective of the re-securitization process is to provide a new source of corporate financing. For example, these transactions may increase the likelihood that the highly rated RE-REMIC security will be accepted as collateral at attractive rates (e.g., at the Federal Home Loan Banks). The transaction also increases the overall marketability of the instrument should the security be marketed for sale at some future date.

10.4 Accounting for securitization transactions

At a conceptual level, the securitization process can result in identification of various financial components (i.e., economic benefits or obligations) related to the transferred financial assets. Examples of financial components that arise in a securitization include servicing assets or liabilities, recourse obligations or various beneficial interests in the cash flows from the securitized assets.

10.5 Illustrative examples

In this section, we illustrate the application of the provisions of ASC 860 through the following example transactions:

- Transfers of receivables to a conduit entity that issues asset-backed commercial paper
- Transfers of REMIC securities to a multi-seller securitization entity
- Securitization with transferor call option
All amounts used in these examples are hypothetical and do not necessarily represent the fair value, gains or losses that would result in the types of transactions illustrated. In practice, the amounts depend on the characteristics of the specific assets securitized, the securitization structure and market conditions. Additionally, the transactions described below are assumed to meet the conditions for sale accounting in ASC 860-10-40-5 and the transferor is not required to consolidate the transferee. There is no assurance or presumption that these transactions would meet the conditions for derecognition and nonconsolidation.

10.5.1 Transfer of receivables to a conduit entity that issues asset-backed commercial paper

Illustration 10-1: Transfer of receivables to a conduit entity that issues asset-backed commercial paper

Company B has $100 million of short-term non-interest bearing trade receivables that have an average estimated life of two months. The company has recorded an allowance for bad debts of $1.1 million for these receivables. A commercial bank (Bank X) has formed a “multi-seller” special-purpose finance entity (Securitization Entity C) to finance trade receivables totaling more than $1 billion from more than 20 unrelated companies. In a “two-step” securitization, Company B transfers $95 million of the receivables (book value of $94 million net of the attributable allowance for bad debts) to a bankruptcy-remote entity and then to Securitization Entity C in exchange for net cash proceeds of $93 million. To finance this purchase, Securitization Entity C issues commercial paper collateralized by the short-term trade receivables.

The terms of the transaction are summarized as follows:

- Securitization Entity C issues commercial paper on a continuous basis.
- Company B agrees to service only the trade receivables transferred by Company B into Securitization Entity C. It receives a servicing fee of 0.25% per annum based on the underlying assets’ outstanding principal amount. Because Company B estimates that the benefits of servicing are inadequate, it estimates the fair value of the servicing contract to be a liability of $0.5 million.
- Company B has the ability, but is not required, to transfer additional newly-originated receivables (up to an additional $50 million) for a two-year period under the same terms as the original sale. The purchase price of future receivables will be determined based on the then current commercial paper rates. At inception, based on the terms of the contract, the put option is assumed to have a fair value of zero.
- Company B provides limited recourse to Securitization Entity C by agreeing to repurchase defaulted receivables at their face amount and bear the effect of any dilution caused by sales returns, rebates, discounts, etc. The fair value of the recourse liability is estimated to be $1.3 million. Bank X also arranges third-party letters of credit to provide backup credit and liquidity enhancements.
- Bank X (as sponsoring bank) retains the benefits from, or is at risk for (except for the limited recourse provided by Company B), any positive or negative spread between the amount collected from the receivables (i.e., $95 million) and the amounts due to the holders of the commercial paper and other administrative expenses of Securitization Entity C. Accordingly, Company B is not entitled to receive any future payments with respect to the transferred receivables except for the servicing fees of 0.25%.
- Company B has concluded that it should not consolidate Securitization Entity C and that the transfer qualifies for sale accounting.
In connection with the sale, Company B has acquired or become obligated with respect to the following newly-created financial instruments (amounts shown in millions):

<table>
<thead>
<tr>
<th>Asset acquired</th>
<th>Estimated fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Put option with respect to future receivables</td>
<td>$ –</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Obligations incurred</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Recourse obligation</td>
<td>1.3</td>
</tr>
<tr>
<td>Servicing liability</td>
<td>0.5</td>
</tr>
</tbody>
</table>

The following illustrates the loss on sale calculation (amounts shown in millions):

<table>
<thead>
<tr>
<th>Receivables sold of $95.0, net of related allowance for bad debts of $1.0</th>
<th>$ 94.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds received from transaction</td>
<td>$ 93.0</td>
</tr>
</tbody>
</table>

**Newly-created interest (at fair value)**

<table>
<thead>
<tr>
<th>Recourse obligation</th>
<th>(1.3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Servicing liability</td>
<td>(0.5)</td>
</tr>
</tbody>
</table>

**Net proceeds received**

<table>
<thead>
<tr>
<th>Net proceeds received</th>
<th>$ 91.2</th>
</tr>
</thead>
</table>

**Loss on sale**

<table>
<thead>
<tr>
<th>Loss on sale</th>
<th>$ (2.8)</th>
</tr>
</thead>
</table>

The loss on the sale of the receivables arises from the following three unrelated factors:

1. Because the receivables are non-interest bearing, the price at which they are sold reflects a discount from their face amount of $2 million ($95 million – $93 million). This discount is required to enable Securitization Entity C to pay interest on its commercial paper. The discount also reflects the market return required in exchange for accepting the risk of non-performance beyond the limited recourse provided by the transferor. However, because the receivables are financed in an off-balance-sheet manner, there will not be any subsequent interest expense attributable to funding the receivables. Accordingly, this portion of the loss is often thought of as an acceleration of the cost of funding the receivables over their lives.

2. The contractual servicing fee is less than adequate compensation that would be required to contract with an unrelated party to assume the servicing obligation. As a result, Company B estimates that it has an initial liability (the fair value of which is $0.5 million) arising from the servicing arrangement. At the date of the transaction, this amount would be considered as a reduction of proceeds.

3. The fair value of the recourse obligation ($1.3 million) exceeds the recorded allowance for bad debts ($1 million). The fair value of the recourse obligation generally will exceed the amount of allowances for bad debts. This is primarily because the fair value of the receivables reflects the risk of expected losses in the portfolio, which are typically in excess of those that are currently considered to be probable of occurring and recognized under the incurred loss model for recognizing impairments. The fair value of the recourse obligation will also include a risk premium based on the level of volatility of potential losses. Additionally, the fair value provides a profit to a third party for assuming the recourse obligation risk.
### Balance sheet comparison (in millions)

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$—</td>
<td>$93.0</td>
</tr>
<tr>
<td>Trade receivables, net of allowance for bad debt</td>
<td>98.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Put option(^1) with respect to future receivables</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$98.9</td>
<td>$97.9</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recourse obligation(^2)</td>
<td>$—</td>
<td>$1.3</td>
</tr>
<tr>
<td>Servicing liability</td>
<td>—</td>
<td>0.5</td>
</tr>
<tr>
<td>Equity</td>
<td>98.9</td>
<td>96.1</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$98.9</td>
<td>$97.9</td>
</tr>
</tbody>
</table>

\(^1\) The put option is assumed to have met the definition of a derivative instrument as described in ASC 815, *Derivatives and Hedging*. Derivative instruments within the scope of ASC 815 are initially recognized and subsequently measured at fair value (refer to ASC 815-10-35-1 and 35-2).

\(^2\) ASC 460, *Guarantees*, provides guidance for initial recognition and measurement of guarantees (which include recourse obligations) that are within its scope. However, ASC 460 does not provide guidance for subsequent measurement of such guarantees. A guarantee that is also a derivative instrument pursuant to the provisions of ASC 815 should be subsequently measured at fair value. Chapter 6, *Recognition and measurement*, provides a brief discussion of appropriate subsequent measurement alternatives.

### Other accounting considerations

Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. As new receivables are sold, rights to service them may become assets or liabilities that are recognized. In many situations, companies that engage in these types of securitization programs commit all newly-originated receivables to the program and establish procedures so that all collections are remitted directly to the commercial paper conduit. In these situations, the sale of receivables occurs contemporaneously with its origination.

In the example above, the calculation of loss on sale does not consider certain direct transaction costs typically associated with securitization transactions (see section 6.3.1 for additional information and a listing of commonly incurred transaction costs). ASC 860-20-35-10 specifies that transaction costs relating to a sale of the receivables may be recognized over the initial and reinvestment periods in a rational and systematic manner unless the transaction results in a loss. Transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. In a credit card securitization, however, some of the transaction costs incurred at the outset relate to the future sales that are to occur during the revolving period, and thus can qualify as an asset. Although ASC 860-20-35-10 specifically refers to credit card securitizations, we believe this guidance is applicable to all revolving-period securitizations.
### Transfers of REMIC securities to a multi-seller securitization entity

**Illustration 10-2: Transfers of REMIC securities to a multi-seller securitization entity**

Company B owns $1 billion of residential mortgaged-backed REMIC securities made up of various classes from multiple REMIC issuances. These securities are classified as available-for-sale securities in its investment portfolio. In December 2010, Company B decides to re-securitize its investments in REMIC securities primarily to: (a) raise cash, (b) obtain new securities with enhanced loss protection and (c) obtain more favorable regulatory capital treatment. To assist Company B and others, Bank A (acting as a sponsor) forms a “multi-seller” special-purpose securitization entity (RE-REMIC trust) to purchase Company B’s REMIC securities and issue new RE-REMIC securities.

On 31 December 2010, in a “two-step” securitization, Company B transfers its entire portfolio of REMIC securities to a bankruptcy-remote entity and then to the RE-REMIC trust. The amortized cost basis and fair value of the REMIC securities on the transfer date are $1 billion and $814.4 million, respectively. In exchange for the securities, Company B receives cash of $424.2 million and RE-REMIC securities with an estimated fair value of $392.2 million.

Other terms of the transaction are summarized as follows:

- Bank A’s fees are fixed and paid from the proceeds from the sale of RE-REMIC securities.
- An independent third party trustee is appointed to manage the affairs of the trust including servicing the RE-REMIC securities by collecting the cash flows from the underlying REMIC securities and passing them through to the holders of the RE-REMIC securities. The trustee’s servicing fee is fixed and is subject to cancellation provisions that are customary for such contracts. The activities of the trustee are considered ministerial in nature (i.e., they do not have any real effect on credit risk or prepayment risk and therefore should not be considered to represent power to direct activities in the consolidation analysis).
- Company B has concluded that consolidation of the RE-REMIC trust is not required and the transfer qualifies for sale accounting.

The following illustrates the loss on sale calculation (amounts shown in millions):

<table>
<thead>
<tr>
<th>Proceeds from sale of REMIC securities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$ 424.2</td>
</tr>
<tr>
<td>Newly-created interests received (at fair value)</td>
<td></td>
</tr>
<tr>
<td>RE-REMIC securities</td>
<td>392.2</td>
</tr>
<tr>
<td>Proceeds from sale</td>
<td>816.4</td>
</tr>
</tbody>
</table>

**Less: Carrying value of the available-for-sale (AFS) securities**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000 cost basis, less unrealized loss of $185.6</td>
<td>(814.4)</td>
</tr>
<tr>
<td>Other comprehensive income (OCI) – unrealized loss</td>
<td>(185.6)</td>
</tr>
<tr>
<td>Loss on sale</td>
<td>$ (183.6)</td>
</tr>
</tbody>
</table>

---

1 Overall, the RE-REMIC securities received by Company B are assumed to be of higher quality than the REMIC securities originally transferred by Company B into the RE-REMIC trust. As a result of the enhanced credit quality, the RE-REMIC securities are presumably more easily traded in the marketplace and command a relatively higher price than the securities transferred to the RE-REMIC trust.

2 This example assumes that Company B’s decision to sell and actual sale of the REMIC securities occurs in the same reporting period. Otherwise, an other-than-temporary impairment would have been recognized in an earlier period in accordance with ASC 320, *Investments—Debt and Equity Securities*, if the company intended to sell the impaired securities before their recovery.
### Securitization with transferor call option

**Illustration 10-3: Securitization with transferor call option**

Company A originates $100 million of mortgage loans that yield 13% interest (a fixed rate) and have an average estimated life of five years. Company A transfers $100 million of such loans in a two-step securitization transaction to Securitization Entity F, which raises $100 million by issuing floating rate senior bonds at LIBOR + 1% to third-party investors. Company A places $5 million into a “spread account,” which provides credit enhancement as losses are charged against it. The initial $5 million deposit is funded by Company A by allocating a portion of the cash proceeds received from the transfer of the loans. Additionally, through the spread account, Company A retains the rights to any excess spread (an interest-only strip).

The terms of the transaction are summarized as follows:

- The excess interest income (interest-only strip) retained by Company A accumulates in the spread account retained within the structure. Any defaulting mortgage loans for which any required payment becomes 90 days past due will be treated as being repaid in full by utilization of funds that are in the spread account.

- The spread account / interest-only strip has a fair value of $6 million, which represents the present value of the estimated excess spread after deducting the (a) contractual servicing fees, (b) floating rate of interest to the bondholders and (c) expected principal and interest losses due to borrower defaults (which in this example are assumed to equal the value of the cash allocated to fund the spread account – that is, $5 million). Company A will continue to provide limited servicing activities for the loans under a servicing contract that stipulates a fee of 1% of the outstanding balances, which represents more than adequate compensation. This contract is deemed to result in an asset of $100 thousand.

- Company A has concluded that it should not consolidate Securitization Entity F. Additionally, the criteria of ASC 860-10-40-5 for the transaction to be treated as a sale have been met, except for a call option retained by Company A that permits it to acquire specified loans that make up 20% of the total amount transferred.¹

### Balance sheet comparison (in millions)

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>REMIC securities, available-for-sale</td>
<td>814.4</td>
<td>-</td>
</tr>
<tr>
<td>RE-REMIC securities</td>
<td>-</td>
<td>392.2</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$ 814.4</td>
<td>$ 816.4</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OCI – unrealized (loss)</td>
<td>(185.6)</td>
<td>-</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,000.0</td>
<td>816.4</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>814.4</td>
<td>816.4</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$ 814.4</td>
<td>$ 816.4</td>
</tr>
</tbody>
</table>
The following illustrates the gain on sale calculation (amounts shown in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sale of loans</td>
<td>$100.0</td>
</tr>
<tr>
<td>Newly-created interest (at fair value)</td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0.1</td>
</tr>
<tr>
<td>Spread account / Interest-only strip</td>
<td>6.0</td>
</tr>
<tr>
<td>Reduction of proceeds</td>
<td></td>
</tr>
<tr>
<td>Initial deposit to spread account</td>
<td>(5.0)</td>
</tr>
<tr>
<td>Amount attributable to loans not considered sold</td>
<td>(20.0)</td>
</tr>
<tr>
<td>Net proceeds of sale</td>
<td>81.1</td>
</tr>
<tr>
<td>Less: carrying value of loans sold</td>
<td>(80.0)</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$1.1</td>
</tr>
</tbody>
</table>

1. It should be noted that if the call had provided Company A with the right to repurchase any loan transferred up to a total aggregate purchase of 20% of the initial balance of the securitized pool of loans, none of the loans would have been considered sold until 20% of the pool was repurchased.

2. In the example above, the calculation of gain on sale does not consider transaction costs typically associated with securitization transactions. See section 6.3.1 for additional information and a listing of commonly incurred transaction costs.

**Balance sheet comparison (in millions)**

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ –</td>
<td>$95.0</td>
</tr>
<tr>
<td>Loans</td>
<td>100.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Spread account / Interest-only strip</td>
<td>–</td>
<td>6.0</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>–</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$100.0</td>
<td>$121.1</td>
</tr>
<tr>
<td><strong>Liabilities and equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities$^5$</td>
<td>$ –</td>
<td>$20.0</td>
</tr>
<tr>
<td>Equity</td>
<td>100.0</td>
<td>101.1</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$100.0</td>
<td>$121.1</td>
</tr>
</tbody>
</table>

3. Because the terms of the securitization structure stipulate that the delinquent mortgage loans will be repaid from funds that are available in the spread account / interest-only strip, and there is no further recourse against the transferor (Company A), we consider the transferor to have a single beneficial interest in transferred assets that is valued net of the expected losses arising from accounts that become delinquent.

The subsequent measurement for an interest-only strip that is not a derivative, is included in ASC 325-40, Investments–Other – Beneficial Interests in Securitized Financial Assets, which generally requires such instruments to be classified and measured as an available for sale investment or as trading investment. Also refer to section 6.5.2.1 for subsequent measurement considerations for an interest-only strip.

4. A servicing asset (or servicing liability) is subsequently measured either at fair value through earnings or at amortized cost, subject to impairment (or increased obligation). Refer to Chapter 7, Servicing of financial assets, and ASC 860-50-35 for further information.

5. Cash proceeds related to a transferred asset that does not qualify for sale accounting is initially recognized with an offsetting liability. The transferred asset is effectively collateral for a secured borrowing transaction. Unless a fair value option is elected, the recognized liability is subsequently reduced only when the conditions in ASC 405-20-40-1 are met. Generally, the liability has recourse to only the transferred assets and, therefore, there are no subsequent increases in the measurement of the obligation.
11

Disclosures

11.1 Introduction

ASC 860’s disclosure requirements apply to both public and nonpublic entities. As with any disclosure requirements, the relevance of the information being disclosed as well as the significance to the overall financial statements will differ among entities based on the nature and size of affected transactions, the types of assets transferred and forms of continuing involvement, among other reasons. Such factors should be considered in developing the most meaningful disclosures.

11.2 Objectives

The principal objectives of ASC 860’s disclosure requirements are to provide financial statement users with an understanding of the nature and extent of a transferor’s continuing involvement with transferred financial assets and how a transfer affects a transferor’s financial statements.

Excerpt from Accounting Standards Codification

860-10-50

50-3 The principal objectives of the disclosure requirements of this Topic are to provide financial statement users with an understanding of all of the following:

a. A transferor’s continuing involvement, if any, with transferred financial assets

b. The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets

c. How servicing assets and servicing liabilities are reported under Subtopic 860-50

d. For both of the following, how the transfer of financial assets affects an entity’s financial position, financial performance, and cash flows:

   1. Transfers accounted for as sales, if a transferor has continuing involvement with the transferred financial assets

   2. Transfers of financial assets accounted for as secured borrowings.

50-4 The objectives in the preceding paragraph apply regardless of whether this Topic requires specific disclosures. The specific disclosures required by this Topic are minimum requirements, and an entity may need to supplement the required disclosures depending on any of the following:

a. The facts and circumstances of a transfer

b. The nature of an entity’s continuing involvement with the transferred financial assets

c. The effect of an entity’s continuing involvement on the transferor’s financial position, financial performance, and cash flows

Disclosures required for a particular form of continuing involvement shall be considered when determining whether the disclosure objectives of this Topic have been met.
The FASB included the overall disclosure objectives because it is not possible to develop specific disclosure requirements that would anticipate all existing and future transactions. Nonetheless, the FASB developed an extensive list of specific required disclosures.

The disclosure objectives apply even when there is no specific rules-based requirement or the specific required disclosures do not adequately meet the objectives. Entities should also consider disclosures required by other US GAAP (e.g., for derivatives, guarantees, beneficial interests) when determining whether the disclosure objectives have been met.

The FASB considered leading practices in developing its disclosure requirements, including the April 2008 Senior Supervisors Report, Leading-Practice Disclosures for Selected Exposures,97 which was issued by banking commissions and regulators from five countries. We believe entities may find this report helpful in developing their disclosures.

11.3 Aggregation of financial information

ASC 860-10-50-4A through 50-7 provide guidance about whether disclosure requirements should be made at the individual transfer level or for a group of similar transfers.

<table>
<thead>
<tr>
<th>Excerpt from Accounting Standards Codification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>860-10-50</strong></td>
</tr>
<tr>
<td><strong>50-4A</strong> Disclosures required by this Topic may be reported in the aggregate for similar transfers if separate reporting of each transfer would not provide more useful information to financial statement users. A transferor shall both:</td>
</tr>
<tr>
<td>a. Disclose how similar transfers are aggregated</td>
</tr>
<tr>
<td>b. Distinguish between transfers that are accounted for as secured borrowings and transfers that are accounted for as sales.</td>
</tr>
<tr>
<td><strong>50-5</strong> In determining whether to aggregate the disclosures for multiple transfers, the reporting entity shall consider quantitative and qualitative information about the characteristics of the transferred financial assets, including all of the following:</td>
</tr>
<tr>
<td>a. The nature of the transferor’s continuing involvement[98]</td>
</tr>
<tr>
<td>b. The types of financial assets transferred[99]</td>
</tr>
<tr>
<td>c. Risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the change in the transferor’s risk profile as a result of the transfer</td>
</tr>
<tr>
<td>d. The guidance in paragraph 310-10-50-25 (for risks and uncertainties) and paragraphs 825-10-55-1 through 55-2 (for concentrations involving loan product terms).[100]</td>
</tr>
</tbody>
</table>

98 EY note: The ASC Master Glossary defines continuing involvement as any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. For related implementation guidance, see ASC 860-10-55-79A and 55-79B.
99 EY note: We believe an entity may aggregate disclosures based upon a combination of the transferred financial assets’ (a) legal form (e.g., equity interests vs. debt interests) and (b) nature (e.g., trade receivables, securities, mortgages). Additionally, an entity may consider information about the underlying financial assets’ geographic origin, asset type and credit risk.
100 EY note: The guidance in ASC 310-10-50-25 and ASC 825-10-55-1 was previously included in FSP SOP 94-6-1, Terms of Loan Products That Give Rise to a Concentration of Credit Risk.
In determining whether to aggregate the disclosures for multiple transfers, we believe a transferor may consider the following factors, among others, when addressing the requirements in ASC 860-10-50-5(c) and 50-5(d):

- Form of continuing involvement – for example, whether through beneficial interests received as proceeds, derivatives (such as total return swaps), or commitments to provide liquidity and/or credit support
- Information related to the risk associated with the continuing involvement, including the extent of impairments recognized on any beneficial interests received as proceeds
- Amount of continuing involvement that is hedged and how it is hedged
- How continuing involvement is valued and the nature of the assumptions used to value continuing involvement

Excerpt from Accounting Standards Codification

860-10-50

50-6 The disclosures shall be presented in a manner that clearly and fully explains to financial statement users the transferor’s risk exposure related to the transferred financial assets and any restrictions on the assets of the entity. The entity shall determine, in light of the facts and circumstances, how much detail it must provide to satisfy disclosure requirements of this Topic and how it aggregates information for assets with different risk characteristics. The entity shall strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not assist financial statements users to understand the entity’s financial position. For example, an entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of involvement or associated risks.

50-7 To apply the disclosures required in this Topic, an entity shall consider all involvements by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents to be involvements by the transferor.

11.4
Specific disclosure requirements

11.4.1
Transfers of financial assets accounted for as sales

Excerpt from Accounting Standards Codification

860-20-50-2

Paragraphs 860-20-50-3 through 50-4 address disclosures for securitizations, asset-backed financing arrangements, and similar transfers that have both of the following characteristics:

a. The transfer is accounted for as a sale
b. The transferor has continuing involvement with the transferred financial assets.

For transfers of financial assets accounted for as sales in which the transferor has continuing involvement, ASC 860 requires certain disclosures for each period an income statement is provided (e.g., three years for most SEC registrants), while other disclosures are required only for the periods for which statements of financial position are provided (e.g., two years for most SEC registrants).
### 11.4.1.1 Disclosures for each income statement presented

**Excerpt from Accounting Standards Codification**

**860-20-50**

For each income statement presented, the entity shall disclose all of the following:

1. **a.** [Subparagraph superseded by Accounting Standards Update No. 2009-16]
2. **b.** The characteristics of the transfer including all of the following:
   1. A description of the transferor’s continuing involvement with the transferred financial assets
   2. The nature and initial fair value of both of the following:
      1. The asset obtained as proceeds
      2. The liabilities incurred in the transfer.
   3. The gain or loss from sale of transferred financial assets.
3. **bb.** For the initial fair value measurements in item (b)(2), the level within the fair value hierarchy in Topic 820 in which the fair value measurements fall, segregating fair value measurements using each of the following:
   1. Quoted prices in active markets for identical assets or liabilities (Level 1)
   2. Significant other observable inputs (Level 2)
   3. Significant unobservable inputs (Level 3).
4. **c.** For the initial fair value measurements in item (b)(2), the key inputs and assumptions used in measuring the fair value of assets obtained and liabilities incurred as a result of the sale that relate to the transferor’s continuing involvement, including quantitative information about all of the following:
   1. Discount rates.
   2. Expected prepayments including the expected weighted-average life of prepayable financial assets. The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.
   3. Anticipated credit losses, including expected static pool losses. If an entity has aggregated transfers during a period in accordance with the guidance beginning in paragraph 860-10-50-5, it may disclose the range of assumptions.
5. **cc.** For the initial fair value measurements in item (b)(2), the valuation technique(s) used to measure fair value.
6. **d.** Cash flows between a transferor and transferee, including all of the following:
   1. Proceeds from new transfers
   2. Proceeds from collections reinvested in revolving-period transfers
3. Purchases of previously transferred financial assets
4. Servicing fees
5. Cash flows received from a transferor’s interests.

**Sales of Loans and Trade Receivables**

50-5 The aggregate amount of gains or losses on sales of loans or trade receivables (including adjustments to record loans held for sale at the lower of cost or fair value) shall be presented separately in the financial statements or disclosed in the notes to financial statements. See Topic 310 for a full discussion of disclosure requirements for loans and trade receivables.

### 11.4.1.2

**Disclosures for each statement of financial position presented**

**Excerpt from Accounting Standards Codification**

860-20-50-4

For each statement of financial position presented, regardless of when the transfer occurred, an entity shall disclose all of the following:

a. Qualitative and quantitative information about the transferor’s continuing involvement with transferred financial assets that provides financial statement users with sufficient information to assess the reasons for the continuing involvement and the risks related to the transferred financial assets to which the transferor continues to be exposed after the transfer and the extent that the transferor’s risk profile has changed as a result of the transfer (including, but not limited to, credit risk, interest rate risk, and other risks), including all of the following:

1. The total principal amount outstanding
2. The amount that has been derecognized
3. The amount that continues to be recognized in the statement of financial position
4. The terms of any arrangements that could require the transferor to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the transferee or its beneficial interest holders, including both of the following:
   i. A description of any events or circumstances that could expose the transferor to loss
   ii. The amount of the maximum exposure to loss.
5. Whether the transferor has provided financial or other support during the periods presented that it was not previously contractually required to provide to the transferee or its beneficial interest holders, including – when the transferor assisted the transferee or its beneficial interest holders in obtaining support – both of the following:
   i. The type and amount of support
   ii. The primary reasons for providing the support.

An entity also is encouraged to disclose information about any liquidity arrangements, guarantees, or other commitments by third parties related to the transferred financial assets that may affect the fair value or risk of the related transferor’s interest.
aa. The entity’s accounting policies for subsequently measuring assets or liabilities that relate to the continuing involvement with the transferred financial assets.

b. The key inputs and assumptions used in measuring the fair value of assets or liabilities that relate to the transferor’s continuing involvement including, at a minimum, but not limited to, quantitative information about all of the following:

1. Discount rates

2. Expected prepayments including the expected weighted-average life of prepayable financial assets (see paragraph 860-20-50-3(c)(2))

3. Anticipated credit losses, including expected static pool losses, if applicable. Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

   If an entity has aggregated transfers during a period in accordance with the guidance beginning in paragraph 860-10-50-5, it may disclose the range of assumptions.

c. For the transferor’s interest in the transferred financial assets, a sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests (including any servicing assets or servicing liabilities) of two or more unfavorable variations from the expected levels for each key assumption that is reported under item (b) of this paragraph independently from any change in another key assumption.

d. A description of the objectives, methodology, and limitations of the sensitivity analysis or stress test.

e. Information about the asset quality of transferred financial assets and any other financial assets that it manages together with them. This information shall be separated between assets that have been derecognized and assets that continue to be recognized in the statement of financial position. This information is intended to provide financial statement users with an understanding of the risks inherent in the transferred financial assets as well as in other financial assets and liabilities that it manages together with transferred financial assets. For example, information for receivables shall include, but is not limited to both of the following:

1. [Subparagraph superseded by Accounting Standards Update No. 2009-16]

2. [Subparagraph superseded by Accounting Standards Update No. 2009-16]

3. [Subparagraph superseded by Accounting Standards Update No. 2009-16]

4. Delinquencies at the end of the period

5. Credit losses, net of recoveries, during the period.

As noted in the requirements above, an entity should disclose the characteristics of the transfer (including a description of the transferor’s continuing involvement with the transferred financial assets, the nature and initial fair value of the assets obtained as proceeds and the liabilities incurred in the transfer) and the gain or loss from sale of transferred financial assets. Historically, some entities using revolving securitization structures had separately disclosed only the gain or loss resulting from the initial securitization and not the gains or losses resulting from the subsequent transfers during the revolving period. However, all gains and losses (both initial and subsequent) must be disclosed.
## 11.4.2 Secured borrowings and collateral

ASC 860-30-50-1A requires certain disclosures for transfers of financial assets accounted for as secured borrowings, including repurchase agreements and securities lending arrangements.

### Excerpt from Accounting Standards Codification

**Collateral**

**860-30-50-1A**

An entity shall disclose all of the following for collateral:

a. If the entity has entered into repurchase agreements or securities lending transactions, it shall disclose its policy for requiring collateral or other security.

b. As of the date of the latest statement of financial position presented, both of the following:
   1. The carrying amount and classifications of both of the following:
      i. Any assets pledged as collateral that are not reclassified and separately reported in the statement of financial position in accordance with paragraph 860-30-25-5(a)
      ii. Associated liabilities.
   2. Qualitative information about the relationship(s) between those assets and associated liabilities; for example, if assets are restricted solely to satisfy a specific obligation, a description of the nature of restrictions placed on those assets.

c. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, it shall disclose all of the following:
   1. The fair value as of the date of each statement of financial position presented of that collateral
   2. The fair value as of the date of each statement of financial position presented of the portion of that collateral that it has sold or repledged
   3. Information about the sources and uses of that collateral.

Repurchase agreements and securities lending activities can vary considerably in practice. Given the various risk management practices in place, policies for collateral and other security may significantly affect the amount of credit risk, market risk, settlement risk and other risks an entity assumes. Accordingly, an understanding of an entity’s credit risk management practices may be useful to investors, creditors and other users of financial statements in assessing the amount of exposure an entity retains for transactions accounted for as borrowings. Regarding ASC 860-30-50-1A(a), we believe an entity’s disclosure about its policy of requiring collateral or other security for such financing transactions should include:

- The types of transactions the entity enters into
- The types of assets that are provided or received as collateral
- Whether collateral levels are monitored and how often they are monitored
- Other significant aspects of the arrangement
Excerpt from Accounting Standards Codification

Repurchase Agreements and Securities Lending Transactions

860-30-50-6

A reporting entity also shall disclose the information required by paragraphs 210-20-50-1 through 50-6 for both of the following that are either offset in accordance with Section 210-20-45 or subject to an enforceable master netting arrangement or similar agreement:

a. Recognized repurchase agreements and reverse sale and repurchase agreements
b. Recognized securities borrowing and securities lending transactions.

In January 2013 the FASB issued ASU 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities, to limit the scope of ASU 2011-11, Disclosures about Offsetting Assets and Liabilities, to derivatives (including bifurcated embedded derivatives), repurchase and reverse repurchase arrangements and securities borrowing and lending transactions. The balance sheet offsetting disclosure requirements described in ASU 2011-11 are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The disclosures are required retrospectively for all comparative periods presented.

11.4.2.1

Repurchase and reverse repurchase agreements

For each period that a statement of financial position is presented by a publicly traded entity, SEC Regulation S-X §210.4.08(m) requires certain information about repurchase and reverse repurchase agreements. As indicated in the excerpt below, this information is required on the face of the appropriate financial statement or in appropriately captioned notes to the financial statements.

Excerpt from SEC Regulation S-X

§210.4.08(m)

(m) Repurchase and reverse repurchase agreements.

(1) Repurchase agreements (assets sold under agreements to repurchase).

(i) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount or if there is no carrying amount) of the securities or other assets sold under agreements to repurchase (repurchase agreements) exceeds 10% of total assets, disclose separately in the balance sheet the aggregate amount of liabilities incurred pursuant to repurchase agreements including accrued interest payable thereon.

(ii)(A) If, as of the most recent balance sheet date, the carrying amount (or market value, if higher than the carrying amount) of securities or other assets sold under repurchase agreements, other than securities or assets specified in paragraph (m)(1)(ii)(B) of this section, exceeds 10% of total assets, disclose in an appropriately captioned footnote containing a tabular presentation, segregated as to type of such securities or assets sold under agreements to repurchase (e.g., U.S. Treasury obligations, U.S. Government agency obligations and loans), the following information as of the balance sheet date for each such agreement or group of agreements (other than agreements involving securities or assets specified in paragraph (m)(1)(ii)(B) of this section) maturing (1) overnight; (2) term up to 30 days; (3) term of 30 to 90 days; (4) term over 90 days and (5) demand:

(i) The carrying amount and market value of the assets sold under agreement to repurchase, including accrued interest plus any cash or other assets on deposit under the repurchase agreements; and
11.4.3 Servicing assets and servicing liabilities

ASC 860-50-50-2 through 50-5 require certain disclosures for servicing assets and servicing liabilities, including specific disclosures for those servicing assets and liabilities subsequently measured at fair value or subsequently amortized.
11.4.3.1 Dislosures required for all servicing assets and servicing liabilities

**Excerpt from Accounting Standards Codification**

*860-50-50-2*

For all servicing assets and servicing liabilities, all of the following shall be disclosed:

a. Management’s basis for determining its classes of servicing assets and servicing liabilities.

b. A description of the risks inherent in servicing assets and servicing liabilities and, if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and servicing liabilities.

c. The amount of contractually specified servicing fees, late fees, and ancillary fees earned for each period for which results of operations are presented, including a description of where each amount is reported in the statement of income.

d. Quantitative and qualitative information about the assumptions used to estimate the fair value (for example, discount rates, anticipated credit losses, and prepayment speeds).

Disclosure of quantitative information about the instruments used to manage the risks inherent in servicing assets and servicing liabilities, including the fair value of those instruments at the beginning and end of the period, is encouraged but not required. An entity that provides quantitative information is also encouraged, but not required, to disclose quantitative and qualitative information about the assumptions used to estimate the fair value of those instruments.

11.4.3.2 Determining classes of servicing assets and servicing liabilities

The approach to determining of classes of servicing assets and servicing liabilities varies in practice. ASC 860-50-35-5 states that classes of servicing assets and servicing liabilities shall be identified based on one or both of the following:

(a) The availability of market inputs used in determining the fair value of servicing assets or servicing liabilities

(b) An entity’s method for managing the risks of its servicing assets or servicing liabilities

Other than these conditions, ASC 860 does not provide explicit guidance about how to identify classes of servicing assets or servicing liabilities.

11.4.3.3 Risks inherent in servicing

Certain servicing activities may be more complex than others, depending upon the type of underlying asset that is being serviced. For example, servicing for conventional mortgage loans is less complex than servicing for subprime mortgage loans, which have a higher probability of defaulting and of requiring some form of remediation (e.g., loan modification or foreclosure). The predominant risk characteristics of the underlying assets may include asset type (e.g., mortgage loans vs. auto loans), size, interest rate (fixed vs. floating), date of origination, term and/or geographic location.

The fair value of the related servicing assets and servicing liabilities is directly affected by, among other things, changes in each of the following factors associated with the underlying assets: (a) prepayment speeds, (b) delinquency and default rates and (c) cost of servicing. An entity may develop and implement an economic hedge program to, among other things, mitigate the overall risk of loss due to changes in the fair value of its servicing rights. The success or failure of any economic hedging program may significantly affect the results of an entity’s operations. Each of these risks factors, including an entity’s policies and procedures for mitigating these risks, if any, should be adequately disclosed.
11.4.3.4 Disclosures required for servicing assets and servicing liabilities subsequently measured at fair value

For each period that results of operations are presented, ASC 860 also requires a rollforward of the balances of servicing assets and servicing liabilities subsequently measured at fair value.

**Excerpt from Accounting Standards Codification**

860-50-50-3

For servicing assets and servicing liabilities subsequently measured at fair value, both of the following shall be disclosed:

a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where changes in fair value are reported in the statement of income for each period for which results of operations are presented), including, but not limited to, the following:
   1. The beginning and ending balances
   2. Additions through any of the following:
      i. Purchases of servicing assets
      ii. Assumptions of servicing obligations
      iii. Recognition of servicing obligations that result from transfers of financial assets.
   3. Disposals
   4. Changes in fair value during the period resulting from either of the following:
      i. Changes in valuation inputs or assumptions used in the valuation model
      ii. Other changes in fair value and a description of those changes.
   5. Other changes that affect the balance and a description of those changes.

See Example 2 (paragraph 860-50-55-27) for an illustration of the disclosure requirement in paragraph 860-50-50-3(a).

b. [Subparagraph superseded by Accounting Standards Update No. 2009-16]

11.4.3.5 Disclosures required for servicing assets and servicing liabilities subsequently amortized

A rollforward is also required for servicing assets and servicing liabilities subsequently measured at amortized cost. However, because the reasons for changes in carrying amounts differ between servicing assets or liabilities that are amortized compared to those subsequently measured at fair value, a different rollforward with different line items is required for servicing assets and liabilities subsequently amortized.

**Excerpt from Accounting Standards Codification**

860-50-50-4

For servicing assets and servicing liabilities measured subsequently under the amortization method in paragraph 860-50-35-1(a), all of the following shall be disclosed:

a. For each class of servicing assets and servicing liabilities, the activity in the balance of servicing assets and the activity in the balance of servicing liabilities (including a description of where
Changes in the carrying amount are reported in the statement of income for each period for which results of operations are presented, including, but not limited to, the following:

1. The beginning and ending balances
2. Additions through any of the following:
   i. Purchases of servicing assets
   ii. Assumptions of servicing obligations
   iii. Recognition of servicing obligations that result from transfers of financial assets.
3. Disposals
4. Amortization
5. Application of valuation allowance to adjust carrying value of servicing assets
6. Other-than-temporary impairments
7. Other changes that affect the balance and a description of those changes.

See Example 2 (paragraph 860-50-50-27) for an illustration of the disclosure requirement in paragraph 860-50-50-4(a).

b. For each class of servicing assets and servicing liabilities, the fair value of recognized servicing assets and servicing liabilities at the beginning and end of the period.

c. [Subparagraph superseded by Accounting Standards Update 2009-16]

d. The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 860-50-35-9. If the predominant risk characteristics and resulting stratum are changed, that fact and the reasons for those changes shall be included in the disclosures about the risk characteristics of the underlying financial assets used to stratify the recognized servicing assets in accordance with this paragraph.

d. For each period for which results of operations are presented, the activity by class in any valuation allowance for impairment of recognized servicing assets, including all of the following:
   1. Beginning and ending balances
   2. Aggregate additions charged and recoveries credited to operations
   3. Aggregate write-downs charged against the allowance.

11.4.3.6 Disclosures required for a change in subsequent measurement of servicing assets and servicing liabilities from amortization to fair value

Excerpt from Accounting Standards Codification
860-50-50-5

If an entity (whether public or nonpublic) elects under paragraph 860-50-35-3(d) to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of the fiscal year, the amount of the cumulative-effect adjustment to retained earnings shall be separately disclosed.

Because this adjustment is presented in the statement of operations, we believe that the disclosure should be presented for each period such an adjustment affects a presented statement of operations.
12 Effective date and transition

12.1 Effective date and transition provisions of ASU 2009-16\textsuperscript{101}

ASU 2009-16’s (i.e., Statement 166’s) amendments to ASC 860 are effective as of the beginning of a reporting entity’s first annual reporting period that begins after 15 November 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. For example, it is effective 1 January 2010, for a calendar-year reporting entity. Earlier or retroactive application of ASU 2009-16’s amendments is not permitted and financial assets transferred before the effective date should continue to be accounted for under the previously applicable guidance.

In addition, all qualifying SPEs on or after the effective date should be evaluated for consolidation in accordance with ASC 810.

\begin{quote}
\textbf{Excerpt from Accounting Standards Codification}

\textit{860-10-65-3}

The following represents the transition and effective date information related to FASB Statement No. 166, \textit{Accounting for Transfers of Financial Assets}:

a. The pending content that links to this paragraph shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, and for both of the following:

\begin{itemize}
  \item 1. Interim periods within that first annual reporting period
  \item 2. Interim and annual reporting periods thereafter.
\end{itemize}

b. Earlier application of the pending content that links to this paragraph is prohibited.

c. The recognition and measurement provisions of the pending content that links to this paragraph shall be applied to transfers that occur on or after the effective date.

d. On and after the effective date, existing qualifying special-purpose entities (as defined before giving effect to the pending content that links to this paragraph) shall be evaluated for consolidation by reporting entities in accordance with the applicable consolidation guidance in this Codification. If the evaluation on the effective date results in consolidation, the reporting entity shall apply the guidance in the Transition and Open Effective Date Section of the applicable Subtopic.

e. The disclosure provisions of the pending content that links to this paragraph shall be applied to transfers that occurred both before and after the effective date specified in this paragraph.

f. An entity is encouraged, but not required, to disclose comparative information for periods earlier than the effective date for disclosures that were not required before the effective date of the pending content that links to this paragraph.

g. Comparative disclosures for those disclosures that were not required before the effective date of the pending content that links to this paragraph are required only for periods after the effective date of that pending content.
\end{quote}

\textsuperscript{101} The amendments in ASU 2009-16 to the Accounting Standards Codification are the result of FASB Statement No. 166, \textit{Accounting for Transfers of Financial Assets}. That Statement was issued by the Board on 12 June 2009.
ASC 860-10-65-3(e) requires a transferor to provide the disclosures about its continuing involvement with the transferred financial assets, regardless of whether such transfers accounted for as sales occurred before or after the effective date of ASU 2009-16.

12.2 Effective date and transition provisions of ASU 2011-03

The guidance in ASU 2011-03 is applicable to new transactions and transactions that are modified on or after the first interim or annual period beginning 15 December 2011 (i.e., 1 January 2012 for calendar-year companies). Early adoption is prohibited.

The FASB’s decision to require prospective application of the new guidance grandfathers the existing accounting treatment for repurchase agreements (and other arrangements that both entitle and obligate the transferor to redeem transferred financial assets before maturity) that are entered into before the effective date of ASU 2011-03. For repos that are transacted under a master agreement (e.g., an umbrella agreement) before the effective date of ASU 2011-03, entities are required to continue to consider the collateral maintenance provisions in ASC 860-10-40-24(b) when determining effective control over financial assets that are transferred. For transactions that occur under the same master agreement after the effective date of ASU 2011-03, entities are required to follow the requirements of the ASU and thus exclude the collateral maintenance provisions from an effective control assessment. Refer to Appendix A (section A.2) for background information leading to the issuance of ASU 2011-03 and the former requirements of ASC 860-10-40-24(b).

Questions and interpretive responses

Effects of ASU 2009-16 on prior conclusions

Question 12-1 Transfers before the effective date of ASU 2009-16

Should the accounting for financial asset transfers that occurred prior to ASU 2009-16’s effective date be reassessed upon adoption of its amendments?

No. The recognition and measurement provisions of ASU 2009-16 are effective for transfers of financial assets occurring on or after the beginning of the reporting entity’s first annual reporting period that begins after 15 November 2009. Early adoption or retroactive application is prohibited.

For example, a transfer of a portion of a loan that was accounted for as a sale prior to the effective date of ASU 2009-16, but that does not meet the definition of a participating interest would not be re-recognized by the transferor upon ASU 2009-16’s adoption. However, qualifying SPE’s must be evaluated for consolidation pursuant to ASC 810 upon the effective date of ASU 2009-16’s guidance.

Reconsideration of the effective control criteria after adoption of ASU 2009-16

ASC 860-20-25-8 through 25-13 indicate that an entity should reconsider whether it has regained effective control over transferred financial assets that were previously accounted for as a sale.
ASC 860-10-55-28 indicates that when an entity transfers financial assets and retains no continuing interest in such transferred assets, the assets should be derecognized. However, the guidance is silent as to whether a transfer previously accounted for as a secured borrowing should be reconsidered to determine if control has been relinquished. In practice, we understand that entities have applied the guidance in ASC 860-20-25-8 through 25-13 “in reverse.” That is, if a change results in a transferor surrendering control of the transferred financial assets that were previously accounted for as a secured borrowing and all of the conditions for sale accounting are met, the transferor may derecognize the transferred financial assets and the associated liabilities.

With the issuance of ASU 2009-16, ASC 860-20-25-8 through 25-13 were amended to reflect the removal of the concept of a QSPE. No other significant changes were made to the guidance about changes that result in regaining control. ASU 2009-16 also does not include any transition guidance about how transfers before its adoption should be evaluated after its adoption when an event occurs that requires an entity to reconsider whether it has regained control over transferred financial assets that were previously accounted for as a sale. Additionally, no guidance was added about whether a transfer previously accounted for as a secured borrowing should be reconsidered to determine if effective control has been relinquished.

Several questions have been raised about how transferors should reconsider transfers that occurred prior to the adoption of ASU 2009-16 when a significant change occurs subsequent to the adoption of ASU 2009-16. The questions below explore this issue further.

**Question 12-2**  
Reconsideration of a prior sale

Following the adoption of ASU 2009-16, if an event occurs that requires reconsideration of a prior transfer accounted for as a sale under ASC 860 before its amendment by ASU 2009-16, should the company apply the provisions of ASC 860 before or after the amendments of ASU 2009-16? For example, assume a substantive change to the entity has occurred and consolidation of the transferee is not required under the consolidation guidance of ASC 810 as amended by ASU 2009-17. Does the transferee need to meet the conditions of a QSPE in order to continue to account for the transfer as a sale, rather than as a secured borrowing, when the transferor continues to be involved with the transferred financial assets?

After the adoption date of ASU 2009-16, we believe that subsequent substantive changes that might result in the transferor regaining control of financial assets previously sold should result in a reevaluation of the transfer in accordance with ASU 2009-16. Because ASU 2009-16 eliminates the QSPE concept, the entity need not qualify as a QSPE when the substantive change occurs to achieve sale accounting. However, all the requirements for sale accounting in ASU 2009-16 must be met to continue to account for the transaction as a sale.

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102 The amendments in ASU 2009-17 to the Accounting Standards Codification are the result of FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R). That Statement was issued by the Board on 12 June 2009.

103 The requirements of a QSPE are discussed in ASC 860-40, prior to the amendments of ASU 2009-16.
Consider the following example:

**Illustration 12-1: Reconsideration of prior sale**

Company XYZ transfers financial assets to a QSPE (securitization entity) in June 2009 for cash and 10% of the beneficial interests. The transfer met all of the requirements to be accounted for as a sale. Upon adoption of ASU 2009-16 and ASU 2009-17, Company XYZ determines that the securitization entity is a variable interest entity. However, the Company also concludes that it is not the primary beneficiary. Therefore, Company XYZ does not consolidate the securitization entity under ASU 2009-17.

In June 2010, Company XYZ solicits and obtains the approval of a majority of the beneficial interest holders to modify the governing documents of the securitization entity. As result of the substantive changes, the permitted activities of the securitization entity are no longer “significantly limited and entirely specified,” and the securitization entity no longer meets the requirements of a QSPE as specified in ASC 860 (before its amendment by ASU 2009-16). Assume the transferred assets remain legally isolated\(^{104}\) and Company XYZ does not effectively control\(^{105}\) the transferred assets. Assume also that this change does not affect Company XYZ’s conclusion that it is not the entity’s primary beneficiary.

In this instance, the transferred financial assets and associated liabilities would not be re-recognized by Company XYZ because the securitization entity would be evaluated under ASU 2009-16. Under ASU 2009-16, the “pledge or exchange” derecognition criterion permits the transferor to look through to the beneficial interest holders when evaluating the transferee’s ability to pledge or exchange. Because this requirement, as well as the other conditions for derecognition, are met, we believe sale accounting continues to be appropriate.

**Question 12-3**

Reconsideration of a prior transfer that did not qualify as a sale

Following the adoption of ASU 2009-16, if an event occurs that requires reconsideration of a prior transfer accounted for as a secured borrowing under ASC 860 (before its amendment by ASU 2009-16), should the company apply the provisions of ASC 860 before or after the amendments of ASU 2009-16?

To illustrate the question, consider the following example:

**Illustration 12-2: Reconsideration of a prior transfer that did not qualify as a sale**

Prior to 1 January 2010, Company ABC transfers financial assets (e.g., a group of residential mortgage loans) to a securitization entity. The transfer failed sale accounting because the securitization entity failed one or more of the QSPE conditions specified in ASC 860-40-15-3 through 15-4 (prior to the amendments of ASU 2009-16) and the securitization entity is constrained from pledging or exchanging the transferred financial assets. Subsequent to the adoption of ASU 2009-16, Company ABC removes the impediment that previously precluded derecognition under ASC 860, prior to its amendment by ASU 2009-16. For example, Company ABC removes an ineligible derivative contract or modifies and limits the nature and extent of permissible activities specified in the legal documents that established and govern the entity. Also, assume that the securitization entity meets the definition of a variable interest entity, but Company ABC does not consolidate the entity under the provisions of ASC 810, as amended by ASU 2009-17.

\(^{104}\) Derecognition criteria specified in ASC 860-10-40-5(a).

\(^{105}\) Derecognition criteria specified in ASC 860-10-40-5(c).
It depends. We believe any subsequent substantive modification to a transferor’s forms of continuing involvement with the transferred financial assets should be evaluated based on the accounting guidance in effect at the time of the change. In other words, an entity should apply the derecognition criteria in ASC 860, as amended by ASU 2009-16, for reconsideration events occurring subsequent to ASU 2009-16’s effective date. We believe a change is substantive if it requires the approval of the majority of the third-party investors holding beneficial interests in the securitization entity (transferee). In the example above, eliminating an ineligible derivative contract may not constitute a substantive modification if the transferor can make the decision unilaterally and if the change has no effect on the beneficial interests held by third parties. However, amendments that significantly change the permissible activities of the securitization entity and require the approval of the majority of the third-party investors generally would be substantive.

At the reconsideration date in the example above, if (a) the securitization entity is not consolidated under ASC 810 (as amended by ASU 2009-17) and (b) each of ASC 860’s derecognition requirements (as amended by ASU 2009-16) have been met, then Company ABC should account for the previously transferred assets as a sale.
A

Background on the amendments

A.1

Statement 166 (ASU 2009-16)

On 12 June 2009, the FASB issued Statement 166\(^{106}\) to address practices that have developed since the issuance of Statement 140\(^{107}\) (primarily codified as ASC 860, Transfers and Servicing) and concerns of financial statement users that many of the financial assets that have been derecognized should continue to be reported in the financial statements of transferors. Additionally, financial statement users have expressed concerns about the transparency of disclosures regarding the nature and extent of a transferor’s continuing involvement with transferred financial assets. The objective of Statement 166 is to improve the comparability, relevance and transparency of the information that a reporting entity provides in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor’s continuing involvement in transferred financial assets. To meet those objectives, Statement 166 modifies and clarifies several key principles of the derecognition requirements.

In summary, Statement 166 amends ASC 860 as follows:

- **Removal of the qualifying SPE exception** – It simplifies the accounting for transfers of financial assets by removing the concept of a qualifying SPE and improves comparability in financial reporting by eliminating the exception for qualifying SPEs from the consolidation guidance of FIN 46\(^{108}\)R (codified within ASC 810, Consolidation). As a result, all transferees, including variable interest entities, must be evaluated for consolidation under the applicable accounting guidance unless another scope exception is available.

- **Removal of the guaranteed mortgage securitization exception** – It improves consistency in reported financial information by removing the special provisions for guaranteed mortgage securitizations in Statement 140 and Statement 65\(^{109}\) (codified within ASC 948, Financial Services – Mortgage Banking) and by requiring those securitizations to be treated the same as any other transfer of financial assets within the scope of ASC 860. If such securitizations do not meet the requirements for sale accounting, the securitized mortgage loans should continue to be classified as loans in the transferor’s statement of financial position. Additionally, in those instances the transferor would not separately recognize a servicing asset or servicing liability.

- **Amended unit of account eligible for sale accounting** – It modifies the financial-components approach used in ASC 860 and limits the circumstances in which a transferor derecognizes a portion or component of a financial asset when the transferor has not transferred the original financial asset or when the transferor has continuing involvement with the financial asset. Specifically, it limits the unit of account eligible for sale accounting to: a) an entire financial asset, b) a group of entire financial assets, or c) a participating interest in an entire financial asset. A participating interest is defined as a portion of a financial asset that possesses each of the following characteristics:
  - Represents a proportionate (pro rata) ownership interest in an entire financial asset
  - Entitles each participating interest holder to all the cash flows received from the entire financial asset in proportion to its share of ownership.
• Requires each participating interest holder to have the same priority and no participating interest holder is subordinated to another – that is, it involves no recourse to, or subordination by, any participating interest holder and it does not entitle any participating interest holder to receive cash before any other participating interest holder

• Does not entitle any participating interest holder the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset

• **Clarified legal isolation requirements** – It clarifies the legal isolation analysis to ensure that the financial asset has been put beyond the reach of the transferor and its consolidated affiliates (affiliates that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors.

• **New “look through” provisions for transfers involving securitization entities** – In assessing whether the transferor has constrained the ability of the transferee to pledge or exchange the transferred financial assets, it requires the transferor to “look through” the transferee to consider the abilities of the transferee’s beneficial interest holders to pledge or exchange their beneficial interests when the sole purpose of the transferee entity is to engage in securitization or asset-backed financing activities. Previously, the look-through provisions were applicable only to transactions involving qualifying SPEs.

• **Clarified effective control considerations** – It clarifies the principle in the effective control criteria of ASC 860 that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents effectively control the transferred financial asset(s) directly or indirectly.

   Additionally, when evaluating transfers of financial assets for derecognition, it clarifies that an entity must consider all arrangements or agreements made contemporaneously with, or in contemplation of, a transfer, even if not entered into at the time of the transfer.

• **Amended recognition and measurement requirements** – It provides what the FASB believes is more relevant financial information that better captures the economic substance of many transfers and simplifies the accounting for securitizations of financial assets. For example, it requires that a transferor recognize and initially measure at fair value all assets obtained (including beneficial interests) and liabilities incurred as a result of a transfer of an entire asset or group of financial assets accounted for as a sale. Previously, if a transferor transferred financial assets that met the requirements for sale accounting and retained a beneficial interest in the transferred financial assets, the transferor was required to initially record its retained interest based on an allocation of the previous carrying amount of the transferred financial assets.

• **Removal of the fair value practicability exception** – It removes the practicability exception from measuring the proceeds received by a transferor in a transfer that meets the conditions for sale accounting at fair value.

• **Expanded disclosure requirements** – It supersedes FSP FAS 140-4 and FIN 46R-8,110 (codified in ASC 860 and ASC 810, respectively). However, similar to that superseded guidance, it requires a transferor to provide additional disclosures to help users of financial statements better understand a transferor’s continuing involvement with transferred financial assets, the risks inherent in the transferred financial assets that have been transferred or retained, and the nature and financial effect of restrictions on the transferor’s assets that continue to be reported in the statement of financial position.

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110 FASB Staff Position No. 140-4 and FIN 46R-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*
A.2 **ASU 2011-03**

Repurchase agreements are often entered into to meet short-term cash needs and involve the temporary exchange of securities, usually for other securities or cash of an equivalent value, with an obligation to redeliver a like quantity of the same (or similar) securities at a future date. Most repurchase agreements are structured to give the transferee legal title to the securities for the life of the transaction, even though, economically, the terms are more akin to a loan.

Repurchase agreements have attributes of both sales and secured borrowings. On the one hand, these transactions are typically structured to give the transferee legal title to the securities, thereby providing them the right to income distributions from the transferred assets. These features are consistent with “sale” transactions. On the other hand, the transferor typically has the obligation to repurchase the transferred assets at a predetermined fixed price, which makes the transaction economically similar to a secured borrowing.

Prior to ASU 2011-03, a transferor maintained effective control over transferred financial assets (and thus accounts for the transfer as a secured borrowing) under an agreement that both entities and obligates the transferor to repurchase the financial assets before maturity if all of the following conditions are met:

- The assets to be repurchased or redeemed are the same or substantially the same as those transferred.
- The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (transferor’s ability criterion).
- The agreement is to repurchase or redeem them before maturity at a fixed or determinable price.
- The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

In evaluating the second criterion (that the transferor is able to repurchase the transferred assets on substantially the agreed terms), the Board had previously concluded the transferor’s ability to repurchase is not assured unless it obtains collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract.

Determining what constitutes “substantially all” was often a matter of facts and circumstances. While entities exercised judgment when evaluating the sufficiency of the collateral in a repurchase agreement or securities lending transaction, as the level of collateral moved away from the 98%-102% range previously described in ASC 860-10-55-37, it became increasingly difficult to assert that sufficient collateral existed to meet the requirements of ASC 860-10-40-24(b).

Some also questioned whether this collateral maintenance guidance was useful and necessary for an entity to determine whether it maintained effective control over financial assets transferred because the accounting may not faithfully represent the underlying economics of the transaction.

To address these questions, the FASB concluded that the criterion pertaining to an exchange of collateral should not be a determining factor of effective control. That is, the current FASB believes that the assessment of effective control should focus on a transferor’s contractual rights and obligations with respect to transferred financial assets, not on whether the transferor has the practical ability, by way of a collateral maintenance agreement, to exercise those rights or honor those obligations.

The FASB believes that the remaining criteria are sufficient to determine effective control and as such ASU 2011-03 eliminated the criterion that the transferor be able to repurchase the transferred assets on substantially the agreed terms in determining the accounting for repurchase agreements.
Overview

This appendix includes the derecognition section of our publication entitled *US GAAP/IFRS Accounting Differences Identifier Tool* (the Identifier Tool). The Identifier Tool has been developed to assist entities that are considering a future conversion to IFRS and is typically useful during the diagnostic phase of a conversion project.

The Identifier Tool is intended to help users identify accounting differences between US GAAP and IFRS as of 31 May 2012 that may affect a converting entity’s financial statements. The Identifier Tool focuses solely on accounting differences and is meant to assist in identifying the more common differences between US GAAP and IFRS. However, no resource can possibly identify all of the differences that exist between the two sets of standards, nor is ours intended to. Further, everyone may not agree on whether an accounting difference actually exists. IFRS standards are more broad and “principles-based” than their US counterparts, with limited interpretive guidance. Many differences depend on an entity’s specific industry, the nature and extent of its transactions, and – where choices are available – the accounting policy elections it has made under US GAAP and plans to make under IFRS. Accordingly, the Identifier Tool should be viewed as a starting point for determining accounting differences and not an all-inclusive comprehensive checklist. It is not a substitute for a careful reading of the appropriate US GAAP and IFRS literature, the more comprehensive guidance contained in this overall Financial Reporting Developments (FRD) publication and Ernst & Young’s *International GAAP 2013* publication.

Tool organization

This Identifier Tool includes a discussion of the accounting similarities between the two standards and a list of the relevant primary accounting literature for derecognition effective as of 31 May 2012. Following the Overview is a series of Questions designed to identify significant differences between the two derecognition accounting models. A “Yes” response to the Question indicates the presence of a situation or transaction that could result in a potential accounting difference, while a “No” response indicates that the situation or transaction does not exist for the entity and, therefore, no accounting difference should result.

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111 The information included in this appendix is from the US GAAP/IFRS Accounting Differences Identifier Tool (October 2011, revised November 2012).
Derecognition of financial assets and financial liabilities

Similarities

ASC 860 focuses on legal isolation and control over the transferred financial asset and the ability to exercise that control. The derecognition rules in IAS 39 are based on different accounting concepts, in particular a “risks-and-rewards” model and a “control” model, which may lead to different conclusions. IAS 39 seeks to avoid the potential conflict between those accounting models by requiring, the “risks-and-rewards” model to be applied first and the “control” model second.

Transfer of Financial Assets

Both IFRS and US GAAP permit derecognition of an entire financial asset, a group of entire financial assets or portions of an entire financial asset in certain cases. However, US GAAP and IFRS differ in how they define a portion of a financial asset that is eligible for derecognition (see Question 2).

Both IFRS and US GAAP disallow sales of future revenues. In practice, sales of future revenues are generally accounted for as borrowings by the transferor.

Under both US GAAP and IFRS, transfers of lease residual values that are guaranteed at the inception of the lease are subject to the derecognition requirements of ASC 860 and IAS 39, respectively. However, unguaranteed lease residual values and lease residual values guaranteed after inception of the lease do not meet the definition of financial assets under US GAAP and, therefore, are not subject to the requirements of ASC 860 and continue to be subject to ASC 840, Leases. IFRS considers an unguaranteed residual value to be a part of the lessor's financial asset and, therefore, its derecognition is subject to IAS 39.

Continuing Involvement

A transferor's continuing involvement in transferred financial assets includes any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer (e.g., servicing arrangements, recourse or guarantee arrangements).

If the transferor has no continuing involvement with either the transferred financial assets or the transferee, the transfer typically meets the conditions for sale accounting under both US GAAP and IFRS.

Under IFRS, if an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred financial asset, but retains control of the transferred financial asset, IAS 39 requires the entity to continue to recognize the transferred financial asset to the extent of its “continuing involvement” (the extent to which it is exposed to changes in the value of the transferred financial asset), plus an associated liability.

Under US GAAP, some forms of continuing involvement may result in the transferred financial assets not being legally isolated from the transferor and its creditors, provide the transferor with a unilateral ability to reacquire the transferred financial assets, or constrain the transferee from selling the transferred financial asset, and therefore, enable the transferor to effectively control the transferred financial assets. If a transfer of financial assets fails to meet any of the derecognition conditions in ASC 860, the transfer is accounted for as a secured borrowing with a pledge of collateral.
Initial Measurement of Transfers of Financial Assets that Qualify for Derecognition

Upon completion of a transfer of financial assets that meets the conditions for derecognition, both US GAAP and IFRS provide similar guidance for determining the gain or loss from the sale as well as the carrying amounts of the assets obtained and the liabilities assumed as proceeds. However, because US GAAP and IFRS have different definitions of the unit of account eligible for derecognition and different interpretations of what constitutes a newly-created asset, the measurement of any associated gain or loss may differ under the two accounting standards.

Accounting for Servicing Rights

An entity that transfers financial assets in a transfer that qualifies for sale accounting and retains servicing rights will recognize a servicing asset or liability depending on whether the servicing fee is above or below “adequate compensation.” Under both US GAAP and IFRS, the definition of servicing assets and liabilities, including the requirements for separate recognition, are similar. However, both initial and subsequent measurement of servicing rights differs under the two accounting standards.

Accounting for Transfers of Financial Assets that Fail the Derecognition Requirements

If a transfer of a financial asset (or portion thereof) in exchange for cash or other consideration does not meet the criteria for sale accounting, both US GAAP and IFRS require that the transferor continue to recognize the transferred financial asset and recognize a financial liability for the consideration received (i.e., the transferor accounts for the transfer as a secured borrowing with pledge of collateral). In subsequent periods, the transferor will continue to recognize any income on the transferred financial asset and any expense incurred on the financial liability.

Extinguishment of Financial Liabilities

A debtor derecognizes a liability if and only if it has been extinguished. The criteria for derecognizing liabilities under US GAAP are similar to IFRS. A liability generally has been extinguished if either 1) the debtor pays the creditor and is relieved of its obligation for the liability or 2) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Accounting for Collateral

In many financing transactions, a debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or re-pledge collateral held under a pledge. In a transfer of collateral that is accounted for as a secured borrowing, the recognition of the collateral by the secured party and the reclassification of the collateral by the debtor is similar under both US GAAP and IFRS and depend on whether the secured party has the right to sell or re-pledge the collateral and whether the debtor has defaulted under the terms of the borrowing.

Securities Lending Arrangements

Under US GAAP, an agreement that both entitles and obligates the transferor to repurchase or redeem transferred financial assets from the transferee maintains “effective control” over the assets and requires that the transaction be accounted for as a secured borrowing.
Under IFRS, an entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer. IAS 39 gives securities lending transactions and repurchase agreements as examples of transactions in which an entity has retained substantially all of the risks and rewards of ownership.

The accounting for securities lending transactions and repurchase agreements will often be the same under both US GAAP and IFRS (that is, secured borrowing rather than sale accounting). However, differences in accounting can result because US GAAP focuses on transfer of control while IFRS primarily considers the transfer of risks and rewards of ownership.

<table>
<thead>
<tr>
<th>Primary US GAAP</th>
<th>Primary IFRS</th>
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<tbody>
<tr>
<td>• ASC 860, Transfers and Servicing</td>
<td>• IAS 39, Financial Instruments: Recognition and Measurement</td>
</tr>
<tr>
<td>• ASC 405-20, Extinguishments of Liabilities</td>
<td>• SIC-12, Consolidation – Special Purpose Entities</td>
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<td>• ASC 260, Guarantees</td>
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</table>

**Convergence**

In April 2011, the FASB issued amendments to the accounting requirements for repurchase agreements and similar arrangements that both entitle and obligate the transferor to repurchase or redeem a transferred financial asset before its maturity. ASU 2011-03<sup>112</sup> eliminates the transferor’s “ability” criterion in ASC 860, which requires the transferor to maintain at all times collateral sufficient to fund substantially all of the cost of purchase replacement assets from others. As the transferor’s “ability” criterion is not a requirement under IFRS, this ASU improves convergence. The new guidance is effective for calendar-year entities in the first quarter of 2012.

**Discussion of IFRS 1**

A first-time adopter must apply the derecognition requirements in IAS 39 prospectively to transactions occurring on or after the date of transition to IFRS. If a first-time adopter derecognized non-derivative financial assets or non-derivative financial liabilities under its previous GAAP, it does not recognize those assets and liabilities under IFRS (unless they qualify for recognition as a result of a later transaction or event). However, transfers on or after the date of transition to IFRS are subject to the full requirements of IAS 39 and will have to be re-evaluated to determine whether they meet the criteria for derecognition. Therefore, unless the derecognition requirements of IAS 39 are satisfied, financial assets and financial liabilities transferred after the date of transition to IFRS must be recognized under IFRS.

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<sup>112</sup> Accounting Standards Update No. 2011-03, Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements
A first-time adopter may elect to apply the derecognition requirements in IAS 39 retrospectively from a date of the entity’s choosing. Such an election is permissible provided that the information needed to apply IAS 39 to financial assets and financial liabilities derecognized as a result of past transactions was obtained at the time of initially accounting for those transactions. Therefore, an entity that was not permitted to derecognize transferred financial assets under its previous GAAP may be able to derecognize those assets through retrospective application of IAS 39, provided the entity also retained contemporaneous documentation of its original basis for conclusion. However, the limitation on the retrospective application of IAS 39 helps to prevent the re-estimation of measurements used in the risk-and-rewards analysis pursuant to IAS 39 with the unacceptable benefit of hindsight.

A first-time adopter is not exempt from SIC-12\textsuperscript{113}, which requires consolidation of all special purpose entities (SPEs). In other words, SIC-12 contains no specific transitional or first-time adoption provisions. Accordingly, the SIC-12 requirements with regard to the consolidation of SPEs are fully retrospective for first-time adopters. As a result, previously derecognized assets and liabilities may not remain off-balance sheet upon adoption of IFRS. For example, if under US GAAP an entity derecognized non-derivative financial assets and non-derivative financial liabilities as the result of a transfer to an entity treated as an SPE by SIC-12, those assets and liabilities may be required to be re-recognized on transition to IFRS, as the result of consolidation of the SPE rather than through application of IAS 39. However, if the SPE itself then subsequently transferred the asset and achieved derecognition of the items concerned under the entity’s previous GAAP (other than by transfer to a member of the entity’s group or a second consolidated SPE), then the items remain derecognized on transition.

Refer to the Consolidations section of this publication for additional guidance.

| 1. Has the reporting entity transferred an entire financial asset or groups of entire financial assets to an entity (including a special-purpose entity) and derecognized such assets? If no, Questions 2 through 7 do not need to be answered and evaluated. |
|---|---|---|
| Yes | No |

Under US GAAP and IFRS, financial assets consist of cash, evidence of ownership interest in an entity, or a contract that conveys to one entity a contractual right (1) to receive cash financial instrument from a second entity or (2) to exchange other financial instruments on potentially favorable terms with the second entity.

Under US GAAP a transfer is defined as the conveyance of a noncash financial asset (or a portion thereof) by and to someone other than the issuer of that financial asset. Although IFRS does not explicitly define transfers, we understand that transfers under US GAAP are generally considered transfers under IFRS.

Several factors must be evaluated to determine whether a transfer of financial assets constitutes a sale and, if so, the determination of any resulting gain or loss.

\textsuperscript{113} SIC 12 will be superseded when entities adopt, IFRS 10, which is effective for annual periods beginning on or after 1 January 2013.
<table>
<thead>
<tr>
<th>US GAAP – 860-10-40 and 860-10-55</th>
<th>IFRS – IAS 39.15-.23, .30 to .35 and .AG36 to AG51</th>
</tr>
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</table>
| A transferor can derecognize financial assets (i.e., achieve sale accounting) when control has been surrendered over the financial assets. Control has been surrendered if and only if all of the following conditions are met:  
- **Legal isolation of the transferred financial assets:** The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor, including any of its consolidated affiliates, and its creditors—even in bankruptcy or other receivership.  
- **Transferee’s right to pledge or exchange:** Each transferee (or, if the transferee is a securitization entity, each holder of its beneficial interests), has the right to pledge or exchange the transferred financial assets (or beneficial interests), and no condition both constrains the transferee (or third-party holder of its beneficial interests) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.  
- **Transferor’s surrender of effective control:** The transferor does not maintain effective control over the transferred financial assets or beneficial interests (e.g., through a call option or repurchase agreement). | The derecognition model under IFRS is based on a mixed model that considers both transfer of risks and rewards and control. Derecognition is required in the following cases:  
- When the rights to cash flows from the financial asset have expired  
- When the reporting entity has transferred substantially all risks and rewards from the financial asset  
- When the reporting entity (a) has neither transferred substantially all, nor retained substantially all, the risks and rewards from the financial asset and (b) has not retained control of the financial asset.  

An entity has “transferred” a financial asset if, and only if, it either:  
(a) Transfers the contractual rights to receive the cash flows of the financial asset; or  
(b) Retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows on to one or more recipients in an arrangement that meets the conditions specified in IAS 39 (a so-called “pass-through arrangement”). An example of a pass-through arrangement is one in which the entity is a special-purpose entity or trust and issues the financial asset. When an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay those cash flows to the eventual recipients, special “pass-through” conditions apply, as explained in IAS 39.19. These conditions are also discussed in Question 2. If the transferor has neither retained nor transferred substantially all of the risks and rewards, the transfer of control is then evaluated. Control is considered to be surrendered if the transferee has the practical ability to unilaterally sell the transferred financial asset to a third party, without restrictions (ability to pledge is not sufficient). There is no legal “isolation in bankruptcy” test that is required to be met under IFRS to demonstrate that control has been surrendered. Lastly, if an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred financial asset, and retains control of the transferred financial asset, the entity continues to recognize the transferred financial asset to the extent of its continuing involvement. The extent of the entity’s continuing involvement in the transferred financial asset is the extent to which it is exposed to changes in the value of the transferred financial asset. In addition, when an entity continues to recognize an asset to the extent of its “continuing involvement,” the entity also recognizes an associated liability and special measurement rules apply (refer to IAS 39.31).
Implications

Differences in accounting for transfers of financial assets are likely to arise between US GAAP and IFRS in situations in which legal control has been retained by the transferor while substantially all risks and rewards have been transferred. For instance, in order to derecognize financial assets under US GAAP, the transferor has to give up control over the transferred financial assets, but does not have to transfer substantially all risks and rewards of ownership in order to achieve sale accounting.

IFRS primarily allows financial assets to be derecognized when the entity has transferred substantially all risks and rewards from the financial asset. IAS 39 attempts to clarify that the transfer of risks and rewards should be evaluated by comparing the entity's exposure, before and after the transfer, to the variability in the amounts and timing of the net cash flows of the transferred financial asset. An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the amounts and timing of the net cash flows of the transferred financial asset is no longer significant in relation to the total of such variability (IAS 39.AG39 to AG41). See also Chapter 50 in our EY International GAAP 2012 publication for additional guidance.

Under US GAAP, control is considered to be surrendered if, among other criteria enumerated in ASC 860-10-40-5, the transferee has the ability to sell or pledge the transferred financial assets. Under IFRS, a transferor that has neither retained nor transferred substantially all of the risks and rewards of ownership of a transferred financial asset can still derecognize the asset to the extent it has transferred control over the asset to the transferee — that is, when the transferee has the practical ability to sell the asset unilaterally to an unrelated party without additional restrictions. However, unlike US GAAP, a transferee’s ability to only repledge the assets it receives is not sufficient to evidence surrender of control by the transferor under IFRS.

Lastly, IFRS’ special “pass-through” conditions do not exist under US GAAP. However, some similarities exist to IFRS’ pass-through requirements when the transaction involves the transfer of a portion of an entire financial asset.

<table>
<thead>
<tr>
<th>Identified difference?</th>
<th>Yes</th>
<th>No</th>
<th>Depends on policy election</th>
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<td>Describe:</td>
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<tr>
<th>2. Has the reporting entity achieved partial derecognition by transferring a portion of an entire financial asset?</th>
<th>Yes</th>
<th>No</th>
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<tr>
<td>Groups of banks or other entities may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers interests in the loan to other entities.</td>
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A portion of an entire financial asset is eligible for sale accounting if it meets the conditions of a participating interest. A participating interest is defined in ASC 860-10-40-6A as a portion of a financial asset that possesses each of the following characteristics:

- Represents a proportionate (pro rata) ownership interest in an entire financial asset
- Entitles each participating interest holder to all the cash flows received from the entire financial asset in proportion to their share of ownership
- Requires each participating interest holder to have the same priority and no participating interest holder is subordinated to another—that is, it involves no recourse to, or subordination by, any participating interest holder and it does not entitle any participating interest holder to receive cash before any other participating interest holder
- Does not entitle any participating interest holder the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset

Additionally, the requirements for a participating interest stipulate that certain cash flows should be excluded when evaluating whether all cash flows received from the entire financial asset are divided proportionately among the participating interest holders. Such exclusions include:

- Cash flows allocated as compensation for services performed (if not “significantly above” an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace)
- Proceeds from sales of participating interests (except proceeds that permit the transferor to receive disproportionate cash flows)
- Recourse in the form of an independent third-party guarantee

If the transferred portion of an entire financial asset meets the above conditions of a participating interest, and the sale criteria of ASC 860-10-40-5 are met (see Question 1), the transferor may derecognize the participating interests transferred (i.e., a portion of the loan is derecognized by the transferor to the extent of the participating interest sold to the transferee).

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<tr>
<td>A portion of a financial asset may be considered for derecognition only if the portion meets one of the following three conditions:</td>
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</tr>
<tr>
<td>- The portion comprises only specified identified cash flows from a financial asset (e.g., an interest-only strip)</td>
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</tr>
<tr>
<td>- The portion comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (e.g., 90% of all cash flows from a loan)</td>
<td>- The portion comprises only a fully proportionate (pro rata) share of specifically identified cash flows (e.g., 90% of interest cash flows)</td>
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<tr>
<td>- The portion comprises only a fully proportionate (pro rata) share of specifically identified cash flows (e.g., 90% of interest cash flows)</td>
<td>Additionally, the transfer of a portion of a financial asset generally would be evaluated as a transfer of a financial asset subject to the “pass-through” criteria of IAS 39. For pass-through arrangements, IAS 39 permits derecognition (i.e., sale accounting) only if the following three conditions are met:</td>
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<td>Additionally, the requirements for a participating interest stipulate that certain cash flows should be excluded when evaluating whether all cash flows received from the entire financial asset are divided proportionately among the participating interest holders. Such exclusions include:</td>
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<tr>
<td>- The transferee has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the underlying assets,</td>
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<tr>
<td>- The transferee is prohibited from selling or pledging the underlying asset, and</td>
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<tr>
<td>- The transferee has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. Additionally, the transferee cannot reinvest such cash flows received from the underlying assets, unless they are invested in cash equivalents and interest earned is passed on to the eventual recipients.</td>
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</table>
Implications

A reporting entity that transfers portions of financial assets will need to assess whether the conclusions previously reached under US GAAP will be affected by the adoption of IFRS. For example, transferred portions of an entire financial asset that did not meet the definition of a “participating interest” under US GAAP may be eligible for derecognition under IAS 39 if the criteria described above are met. Additionally, a reporting entity will need to assess if transfers of financial asset portions that achieved sale accounting under US GAAP include provisions that do not meet the pass-through requirements of IAS 39 and, therefore, should be accounted for as a secured borrowing.

Under IFRS, retention of servicing rights in connection with sale of participating interests may be problematic (prevent derecognition of the transferred financial asset) unless cash flows received from the underlying assets are promptly remitted to the transferee or invested in cash equivalents and interest earned is passed on to the transferee. In contrast, under US GAAP a servicing arrangement that permits the servicer (transferor) to earn and retain interest on cash collected from the underlying assets prior to the contractual payment date(s) to the participating interest holders (transferees) does not prevent derecognition of the transferred participating interest (unless such arrangement causes the transferor to fail the legal isolation requirement). Unlike the participating interest requirements under US GAAP, the pass-through requirements of IFRS do not limit the amount of service fees received as compensation provided such fees are dependent upon the servicing work being performed satisfactorily and that would end upon termination or transfer of the servicing contract.

Under both US GAAP and IFRS, the gain or loss from a transfer of a portion of an entire financial asset that meets the requirements for sale accounting is typically determined based on the difference between the allocated cost basis of the financial asset components derecognized and the proceeds, which includes the fair value of any assets or liabilities that are newly created as a result of the transaction. However, because IFRS and US GAAP have different definitions of the unit of account eligible for derecognition and different interpretations of what constitutes a newly-created asset, the measurement of any associated gain or loss may also differ under the two accounting standards. For example, under US GAAP, if an entire financial asset (e.g., a mortgage loan) is transferred to a securitization entity that it does not consolidate and the transfer meets the conditions for sale accounting, the transferor may obtain an interest-only (I/O) strip as proceeds from the sale. An I/O strip received as proceeds of a sale is initially recognized and measured at fair value under US GAAP. Under IFRS, such a transaction would represent the transfer of a portion of an entire financial asset (i.e., in the case of the mortgage loan, a transfer of 100% of the principal cash flows and a portion of the interest cash flows). Unlike US GAAP, assuming the transfer qualifies for sale accounting under IFRS, the I/O strip would not represent a newly-created asset and, therefore, it would initially be recognized and measured based upon an allocation of the previous carrying amount of the larger financial asset (e.g., the mortgage loan). Assuming the original financial asset transferred was not designated upon initial recognition at fair value through profit or loss, the I/O strip would not initially be recognized at fair value under IFRS. Consequently, the amount of gain or loss recognized upon sale would differ.

Identified difference?

<table>
<thead>
<tr>
<th>Identified difference?</th>
<th>Yes</th>
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</table>

Questions 3 through 5 below are intended to identify differences in accounting for certain forms of continuing involvement associated with securitization transactions, including a transferor’s guarantee, cleanup option and removal-of-accounts provision.
3. Has the reporting entity transferred financial assets to another entity subject to a performance guarantee?

Guarantees can come in many forms and, when provided by a transferor in a transfer of financial assets, represent a form of the transferor’s continuing involvement with the transferred financial assets. For example, a loan guarantee by a transferor is a promise to the transferee to assume a borrower’s debt obligation if the borrower defaults (i.e., fails to repay debt in accordance with the borrower note). Third-party guarantees are sometimes necessary to entice lenders to lend by reducing concerns about the borrower’s ability to repay. In securitization transactions, guarantees may be required by credit rating agencies in order to justify or preserve high credit ratings for certain classes of beneficial interests (securities) issued by the transferee, which are backed by the transferred financial assets.

US GAAP – 860-10-40-4 and 40-5, 460-10

Guarantees may cause a transfer of financial assets to fail sale accounting for two reasons. That is, the guarantee may either:

► Cause the transfer to fail the legal isolation requirements of ASC 860-10-40-5(a), or
► Constrain the transferee’s right to pledge or exchange the transferred financial asset

For example, a freestanding transferor guarantee may effectively constrain a transferee because the transferee may be unlikely to forfeit the benefit of the guarantee (e.g., if the guarantee is sufficiently valuable to the transferee and not transferable). This constraint may also provide the transferor a more-than-trivial benefit (e.g., by knowing the location of such assets if it were to seek to reclaim them or by effectively limiting the ability of such assets to be obtained by a competitor).

Additionally, a guarantee provided by the transferor in conjunction with the sale of a portion of an entire financial asset is a form of recourse that would cause the transfer to fail to meet the participating interest definition. Refer to Question 2 for further information about transfers of portions of financial assets.

Some guarantee or recourse arrangements associated with transfers of financial assets do not preclude sale accounting because the transferor has relinquished effective control (i.e., each of the derecognition criteria of ASC 860-10-40-5 have been met). In those instances, the transferor would fully derecognize the transferred financial assets, recognize a corresponding gain or loss (if any), and record a liability for the guarantee in accordance with ASC 460-10.

For example, assume an entity has a loan portfolio

<table>
<thead>
<tr>
<th>US GAAP – 860-10-40-4 and 40-5, 460-10</th>
<th>IFRS – IAS 39.20(c)(ii), .30 to .35, .AG48 and IAS 18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantees may cause a transfer of financial assets to fail sale accounting for two reasons. That is, the guarantee may either: ► Cause the transfer to fail the legal isolation requirements of ASC 860-10-40-5(a), or ► Constrain the transferee’s right to pledge or exchange the transferred financial asset</td>
<td>Full derecognition of a transferred financial asset can be achieved only if substantially all of the risks and rewards are transferred. If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred financial asset, but retains control of the transferred financial asset, IAS 39 requires the entity to continue to recognize the transferred financial asset to the extent of its “continuing involvement” – that is, the extent to which it is exposed to changes in the value of the transferred financial asset. When the entity’s continuing involvement takes the form of guaranteeing the transferred financial asset, IAS 39 states the extent of the entity’s continuing involvement is the lower of: ► The amount of the asset; and ► The maximum amount of the consideration received that the entity could be required to repay (the “guarantee amount”)</td>
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</tbody>
</table>
carried at $10 million with a fair value of $10.5 million. The entity sells the rights to 100% of the cash flows to a third party for a payment of $10.55 million, which includes a payment of $50K in return for the transferor agreeing to absorb the first $1 million of default losses on the portfolio.

Assuming the transferor meets the derecognition criteria specified in ASC 860-10-40-5, the transferor will derecognize the assets and recognize a liability measured at the fair value of the guarantee (i.e., $50K, assuming this represents a market based premium for the guarantee) in accordance with ASC 460-10. Therefore, the transferor’s continuing involvement in the transaction will be reflected as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>10.55</td>
</tr>
<tr>
<td>Loans transferred</td>
<td>10.00</td>
</tr>
<tr>
<td>Liability ($50 K guarantee)</td>
<td>0.05</td>
</tr>
<tr>
<td>Gain</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Under ASC 460-10, the guarantee described above is initially recorded as a liability at fair value. Subsequently, the guarantee is reduced (by a credit to earnings) as the guarantor is released from risk under the guarantee (e.g., depending on the specific nature of the guarantee, upon either expiration or settlement of the guarantee, by a systematic and rational amortization method, or as the fair value of the guarantee changes.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10.55</td>
</tr>
<tr>
<td>Continuing involvement in assets</td>
<td>1.00</td>
</tr>
<tr>
<td>Loans transferred</td>
<td>10.00</td>
</tr>
<tr>
<td>Liability ($50 K guarantee)</td>
<td>1.05</td>
</tr>
<tr>
<td>Gain</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Over the remaining life of the transaction, the $50K of the liability that represents the consideration received for the guarantee is amortized through earnings on a time proportion basis as required by IAS 18. In addition, the entity will continue to recognize any income arising on the transferred financial asset to the extent of its continuing involvement and will recognize any expense incurred on the associated liability.

(Refer to Chapter 50 of the EY International GAAP 2012 publication for additional guidance.)

### Implications

For transactions occurring on or after the date of transition to IFRS, a reporting entity will need to assess if a transfer that includes a guarantee that achieved sale accounting under ASC 860 would represent “continuing involvement” under IAS 39. In particular, and in contrast to the treatment for transactions that do not qualify for derecognition through retention of risks and rewards, an entity that is determined to have “continuing involvement” in the transferred financial assets under IFRS will need to record a second entry—that is, an asset that represents its continuing involvement in the transferred financial assets and an associated liability, which is often calculated as a balancing figure that will not necessarily represent the proceeds received as the result of the transfer.

Additionally, a reporting entity will need to re-assess transfers of a portion of a financial asset that did not qualify for derecognition under US GAAP because a guarantee associated with the portion transferred caused it to fail the requirements of a participating interest. Depending on its terms, such transfers may achieve sales accounting under IAS 39 and require an entity to recognize an asset to the extent of its continuing involvement and an associated liability initially measured at the guaranteed amount plus the fair value of the guarantee.
Identified difference?

Describe:

Yes ☐ No ☐ Depends on policy election ☐

4. Has the reporting entity transferred financial assets to another entity pursuant to a transfer arrangement that includes a “cleanup call” that would allow the entity (transferor) to liquidate the trust or SPE (the transferee) under specified conditions?

Yes ☐ No ☐

Under both US GAAP and IFRS, a cleanup call is defined as an option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets if the amount of outstanding assets falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.


Under ASC 860-10-40-5(c), a cleanup call is permitted as an exception to the requirement that the transferor has no rights (e.g., call options) or obligations to repurchase the transferred financial assets. That is, not only does a qualifying cleanup call not preclude derecognition (sales accounting), full derecognition of the transferred financial assets is permitted.

**IFRS – IAS 39.15-.23, .30 to .35, AG48 and AG51(m)**

IAS 39.AG51(m) states that “provided a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.” For example, if an entity that transfers assets and retains servicing can demonstrate that the cost of servicing those assets becomes burdensome in relation to the benefits of servicing when the outstanding assets fall to 10% of the original transferred balance, and the entity has neither retained nor transferred substantially all of the risks and rewards of ownership and the transferee is prohibited from selling the transferred financial assets, then the entity will derecognize only 90% of the transferred financial assets.

In addition, when the entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. The associated liability is measured in such a way that the net carrying amount of the transferred financial asset and the associated liability is:

- The amortized cost of the rights and obligations retained by the entity, if the transferred financial asset is measured at amortized cost; or
- Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred financial asset is measured at fair value.

(Refer to paragraph AG48 of IAS 39 and Chapter 50 of EY’s *International GAAP 2012* publication for additional guidance.)
**Implications**

Under ASC 860, a transferor (that is also the servicer) that holds a cleanup call is not precluded from accounting for the transfer of financial assets entirely as a sale. However, IAS 39 allows only partial derecognition of transferred financial assets provided a cleanup call results in an entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee is constrained from selling the assets. Moreover, when an entity continues to recognize an asset to the extent of its “continuing involvement,” the entity also recognizes an associated liability as defined in paragraph 31 of IAS 39. On the other hand, if the transferor transfers substantially all of the risks and rewards of ownership, then full derecognition is achieved under IFRS (i.e., in this instance, the cleanup call would not preclude full derecognition).

**Identified difference?**

Describe:  

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<th>Yes</th>
<th>No</th>
<th>Depends on policy election</th>
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**5. Has the reporting entity transferred financial assets to another entity pursuant to a transfer arrangement that includes a “removal-of-accounts provision” (ROAP)?**

Many transfers of financial assets in securitization transactions (including credit card and other accounts receivable) empower the transferor to reclaim assets subject to certain restrictions. Such a power is often referred to as a “removal-of-accounts provision” or ROAP.


A ROAP does not preclude derecognition of transferred financial assets by the transferor if it does not result in the transferor maintaining effective control over specified transferred financial assets. Whether a ROAP precludes sale accounting depends on whether it allows the transferor to unilaterally cause the return of specific assets and it provides the transferor with more than a trivial benefit. Examples of ROAPs that would not preclude derecognition include those:

- For random removal of excess assets, if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred financial assets
- For defaulted receivables, because the removal would be allowed only after a third party’s action (default) and could not be caused unilaterally by the transferor

However, an unconditional ROAP that allows the transferor to specify the assets that may be removed precludes sale accounting for all transferred financial assets, because such a provision allows the transferor unilaterally to

**IFRS – IAS 39.15-.23 and AG51(l)**

IAS 39.AG51(l) states that “provided that such an option [the ROAP] results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming the transferee cannot sell the assets).” For example, if an entity transfers loan receivables with a carrying amount of $100,000 for proceeds of $100,000 and any individual loan can be called back subject to a maximum of $10,000, $90,000 of the loans would qualify for derecognition.

When the entity continues to recognize an asset to the extent of its continuing involvement, the entity also recognizes an associated liability. The associated liability is measured in such a way that the net carrying amount of the transferred financial asset and the associated liability is:

- The amortized cost of the rights and obligations retained by the entity, if the transferred financial asset is measured at amortized cost; or
remove specific assets. That applies even if the transferor’s right to remove specific assets from a pool of transferred financial assets is limited. For example, if a ROAP is limited to 10% of the fair value of the assets transferred, and all of the assets are smaller than that 10%, none of the transferred financial assets would be derecognized at the time of transfer because no transferred financial asset is beyond the reach of the transferor.

Conversely, if a transferor holds a call option to repurchase at any time a few specified, individual loans from an entire portfolio of loans transferred in a securitization transaction, then sale accounting is precluded only for the specified loans subject to the call, not the whole portfolio of loans.

> Equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred financial asset is measured at fair value.

(Refer to paragraph AG48 of IAS 39 and Chapter 50 of EY’s International GAAP 2012 publication for additional guidance.)

### Implications

Under IFRS, a transferor’s ROAP in a securitization transaction or other asset-backed financing arrangement precludes full derecognition of transferred financial assets when such an option results in the transferor neither retaining nor transferring substantially all the risks and rewards of ownership. In these instances, IFRS permits derecognition, except to the extent of the amount subject to repurchase. Under US GAAP, a ROAP that allows the transferor to reacquire at any time a few specified individual assets from an entire pool of transferred financial assets and provides the transferor with more than a trivial benefit will preclude derecognition only to the extent of those assets subject to the ROAP, not the entire pool. Conversely, an unconditional ROAP that allows the transferor to specify the assets that may be removed from an entire pool of transferred financial assets and provides the transferor with more than a trivial benefit precludes sale accounting for all transferred financial assets.

A ROAP may also be considered a form of continuing involvement under IFRS and consequently require the entity to record a second entry as described above — that is, an asset that represents its continuing involvement in the transferred financial assets and an associated liability, which is often calculated as a balancing figure that will not necessarily represent the proceeds received as the result of the transfer.

### Identified difference?

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Describe:

### 6. Has the reporting entity transferred a financial asset in conjunction with a total return swap with the same transferee?

A total return swap represents a swap agreement in which one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset, which includes both the income it generates and any gains or losses. In total return swaps, the underlying asset, referred to as the reference asset, is usually an equity index, loans or bonds. This asset is owned by the party receiving the set rate payment.

Total return swaps allow the party receiving the total return to gain exposure and benefit from a reference asset without actually having to own it.
A transferor can derecognize a financial asset when effective control has been surrendered. Transfer of substantially all of the risks and rewards of ownership of a financial asset is not a criterion for derecognition under ASC 860. Therefore, an entity that surrenders control over a transferred financial asset can retain substantially all of the risks and rewards of ownership of that asset by concurrently entering into a total return swap with the same counterparty and still achieve sale accounting.

The derecognition model under IFRS is based on a mixed model that considers both transfer of risks and rewards and control. Transfer of control is considered only when the transfer of risks and rewards assessment is not conclusive.

IAS 39 provides examples of when derecognition of a transferred financial asset would be precluded because an entity has retained substantially all the risks and rewards of ownership. One of the examples relates to a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity (IAS39.AG40(c)).

**Implications**

Under US GAAP, an entity may sell a financial asset and retain substantially all of the risks and rewards by concurrently entering into a total return swap with the same counterparty and still achieve sale accounting provided control has been surrendered by meeting the derecognition criteria of ASC 860-10-40-4 and 40-5. In contrast, under IFRS, sale accounting for the same transactions would likely be precluded because the derecognition model requires that substantially all of the risks and rewards be transferred. Consequently, previously derecognized financial assets under US GAAP may be re-recognized under IFRS if an associated total return swap remains open as of the transition date, subject to the transition provisions of IFRS 1.

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<td>Yes ☐ No ☐ Depends on policy election ☐</td>
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**7. Has the reporting entity transferred financial assets and retained servicing rights?**

An entity that transfers financial assets in a transfer that qualifies for sale accounting and retains servicing rights will recognize a servicing asset or liability depending on whether the servicing fee is above or below "adequate compensation." US GAAP defines adequate compensation as the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. The key point of this definition is that adequate compensation is the amount demanded by the marketplace to perform the specific type of servicing; it does not vary according to the specific servicing costs of the servicer. We understand that adequate compensation is similarly interpreted under IFRS.
All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value.

An entity must subsequently measure each class of separately recognized servicing assets and servicing liabilities either at fair value or by amortizing the amount recognized in proportion to an over the period of estimated net servicing income for assets (the excess of servicing revenues over servicing costs) or the period of estimated net servicing loss for servicing liabilities (the excess of servicing costs over servicing revenues). ASC 860 requires that classes of servicing assets and servicing liabilities be identified based on one or both of the following:

- The availability of market inputs used in determining the fair value of servicing assets or liabilities
- An entity’s method for managing the risks of its servicing assets or servicing liabilities

An entity may make an irrevocable decision to subsequently measure a class of servicing assets and servicing liabilities at fair value at the beginning of any fiscal year. An entity that elects to subsequently measure a class of servicing assets and liabilities at fair value must apply that election to all new and existing recognized servicing assets and liabilities within that class. The effect of re-measuring an existing class of servicing assets and liabilities at fair value is reported as a cumulative-effect adjustment to retained earnings as of the beginning of the period of election, and should be separately disclosed.

Upon completion of a transfer of financial assets that qualifies for derecognition, a servicing asset is initially recognized for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset, as defined. Specifically, the previous carrying amount of the larger financial asset (e.g., transferred loans) is allocated between the part that continues to be recognized (which includes the servicing asset) and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer. (Refer to paragraphs 24, AG45 and AG46 of IAS 39 for additional guidance and Chapter 50 of EY’s *International GAAP 2012* publication for illustrative examples.) A separately recognized servicing liability for the servicing obligation is initially recognized at its fair value.

While IAS 39 provides guidance for the initial recognition of servicing assets and liabilities it does not address subsequent measurement considerations because servicing rights do not represent financial assets or financial liabilities. However, IAS 38 provides guidance for servicing assets that meet the definition of an intangible asset. Under IAS 38, an entity is permitted to choose either the “cost model” in paragraph 74 or the “revaluation model” in paragraph 75 (subject to the fair value criterion specified in that standard) as its accounting policy to subsequently measure servicing assets. If a servicing asset meets the definition of an intangible asset, including the fair value criterion of IAS 38, and an entity elects to measure the servicing asset using the “revaluation model” available under that standard, all other assets in its class will also be accounted for using the same model, unless there is no active market for those assets.

Additionally, we believe IAS 37 and IAS 18 provide applicable guidance for the subsequent measurement of servicing liabilities. For example, because the servicing contract represents an obligation to perform a service for a fee, IAS 18 provides relevant guidance for amortizing the servicing liability over the service period, while IAS 37 provides guidance for increasing the liability if the obligation becomes more onerous at a later date.
Implications

Upon completion of a transfer of financial assets that qualifies for derecognition, both US GAAP and IFRS provide guidance for recognition of retained servicing rights. Those rights will result in the recognition of a servicing asset or liability depending on whether the servicing fee is above or below, respectively, “adequate compensation” (see also Question 2 for implications when a transfer involves portions of a financial asset – i.e., a participating interest).

Servicing assets
Under US GAAP, ASC 860 requires an initially recognized servicing asset to be measured at fair value. Thereafter, a reporting entity can choose to re-measure the asset at fair value or amortized cost. In contrast, under IFRS a servicing asset is recognized by allocating the previous carrying amount of the larger financial asset between the part that continues to be recognized (which includes the servicing asset) and the part that is derecognized, based on the relative fair values of those parts on the date of the transfer.

Servicing liabilities
While both US GAAP and IFRS initially require that a separately recognized servicing liability for a servicing obligation be recognized at its fair value, differences in accounting may exist in the subsequent re-measurement of servicing liabilities. Under US GAAP an entity may elect to subsequently amortize a recognized servicing liability (and assess for increased obligation based on fair value at each reporting date) or re-measure the liability at fair value in accordance with the provisions of ASC 860. In contrast, under IFRS a servicing liability is subsequently amortized over the service period in accordance with IAS 18 and assessed for the need to increase the obligation to the extent the contract has become more onerous in accordance with IAS 37.

Identified difference?

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<th>Identified difference?</th>
<th>Yes</th>
<th>No</th>
<th>Depends on policy election</th>
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<tbody>
<tr>
<td>Describe:</td>
<td></td>
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</table>
8. **Has the reporting entity received or pledged collateral in connection with a securities lending transaction or repurchase agreement?**

| Yes | No |

**Securities Lending**
In a typical securities lending transaction, a borrower-transferee provides cash or a security (or pool of securities) as collateral for borrowing a specific security or securities. Typically, the lender-transferor of the security makes a payment to the borrower-transferee of the security known as a “rebate.” A rebate consists of an interest charge, for the cash collateral received by the lender-transferor of the security (assuming cash is received), netted by any loan fee owed by the borrower-transferee for the security it borrowed. The cash collateral received by the lender-transferor is then invested by the lender-transferor, earning a rate higher than the amount rebated. In the situation in which a security is received as collateral rather than cash, the lender-transferor charges a loan fee.

**Repurchase Agreement**
Under a repurchase agreement, the transferor-repo party transfers a security to a transferee-reverse repo party in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated amount of interest. The transferor-repo party is viewed to be the debtor that borrowed cash and transferred securities as collateral while the transferee-reverse repo party is viewed as the secured lender that receives securities as collateral. The transferee-reverse repo party may or may not have the right to sell or re-pledge the securities to a third party during the term of the repurchase agreement.

For purposes of this Question, unless otherwise indicated, the lender-transferor in a securities lending transaction and the transferor-repo party in a repurchase agreement are collectively referred to as the “transferor,” while the borrower-transferee in securities lending transaction and transferee-reverse repo party in a repurchase agreement are collectively referred to as the “transferee.”
An agreement that both entities and obligates the transferor to repurchase or redeem transferred financial assets from the transferee results in the transferor maintaining effective control over those assets. In those instances, the transferor will account for the transfer as a secured borrowing, if and only if all of the following conditions are met (ASC 860-10-40-24):

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred.

b. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

c. The agreement is entered into contemporaneously with, or in contemplation of, the transfer.

Under many agreements to repurchase transferred financial assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the derecognition criteria of ASC 860 will be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same securities as those concurrently transferred is assured.

If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or re-pledging the assets during the term of the repurchase agreement or securities lending arrangement, the transferor has not surrendered control over those assets.

In transactions accounted for as secured borrowings, the cash (or securities that the holder is permitted by contract or custom to sell or re-pledge) received as “collateral” is considered the amount borrowed, and the securities “loaned” are considered pledged as collateral against the cash borrowed and reclassified (i.e., reported separately on the balance sheet) from securities owned in accordance with the requirements of ASC 860. Additionally, in a securities lending transaction, any “rebate” paid to the borrower-transferee of the securities is the interest on the cash the lender-transferor is considered to have borrowed.

However, in some securities lending transactions and repurchase agreements the criteria for sale accounting are met. In those instances, the transferor will account

An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer. IAS 39 gives securities lending transactions and repurchase agreements as examples of transactions in which an entity has retained substantially all of the risks and rewards of ownership.

The following examples come from the application guidance of IAS 39 and illustrate when derecognition is precluded for financial assets transferred concurrently with a securities lending transaction or repurchase agreement:

- If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender’s return or if it is loaned under an agreement to return it to the transferor (IAS 39.AG51(a)).

- If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender’s return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor (IAS 39.AG51(b)).

- If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender’s return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred financial asset at the repurchase date (IAS 39.AG51(c)).

However, a transfer of a financial asset that is subject to a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because substantially all of the risks and rewards of ownership have been transferred (IAS 39.AG51(j)). Likewise, an entity that sells a financial asset, and retains only a right of first refusal to repurchase the transferred financial asset at fair value if the transferee subsequently decides to sell it, will derecognize the asset (IAS 39.AG51(d)).

IAS 39 provides additional application guidance on the treatment of transfers of financial assets that are subject to a forward repurchase agreement that will be settled net (IAS39.AG51(k)). The guidance indicates that the key factor for determining whether derecognition is
for the transaction as a sale of the “loaned” securities for proceeds consisting of the cash (or in the case of securities lending transactions, securities that the holder is permitted by contract or custom to sell or re-pledge) “borrowed” and a forward repurchase commitment, while the transferee recognizes a purchase of the "loaned" securities in exchange for the “collateral” and a forward repurchase commitment. Other transfers that are accompanied by an agreement to repurchase the transferred financial assets that are accounted for as sales include transfers with agreements to repurchase at maturity.

Accounting for Collateral in a Securities Lending Transaction

In a securities lending transaction, the lender-transferor of securities being “loaned” accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received is recognized as the lender-transferor’s asset— as will investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. In addition, if securities that may be sold or re-pledged are received, the lender-transferor of the securities being "loaned” accounts for those securities in the same way as it would account for cash received. In other words, ASC 860 considers securities received by the lender-transferor, which may be sold or re-pledged, to be akin to the proceeds of either a sale of the “loaned” securities or a borrowing secured by them (i.e., the transferor records an asset (to recognize the in-kind proceeds) and a liability (to recognize a related obligation to repay the transferee or return the collateral received).

Repurchase Financings

Under US GAAP a “repurchase financing” represents a repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer. Pursuant to ASC 860-10-40-44, an initial transfer of a financial asset and repurchase financing that are entered into contemporaneously with, or in contemplation of, one another will be considered linked unless all of the following criteria are met at the inception of the transaction:

- The initial transfer and the repurchase financing are not contractually contingent on one another.
- The repurchase financing provides the initial transferor with recourse to the initial transferee upon default.
- The financial asset subject to the initial transfer appropriate remains whether or not the entity has transferred substantially all the risks and rewards of the transferred financial asset.

Accounting for Collateral in a Securities Lending Transaction

Under IFRS, the accounting for cash collateral received in a securities lending transaction is similar to US GAAP. However, unlike US GAAP, a lender-transferor in a securities lending transaction does not recognize on its balance sheet securities received as collateral, including an obligation to return securities received as collateral, even if it has the ability to sell the collateral received. However, if the lender-transferor actually sells the collateral received, it must recognize the proceeds received and an obligation to return the collateral.

(Refer to Chapter 50 of the EY International GAAP 2012 publication for additional guidance.)

Repurchase Financings

The concept of a “repurchase financing,” which is defined only in US GAAP, is not specifically addressed in IFRS (refer to discussion under US GAAP considerations). Consequently, application of the IFRS derecognition rules to “repurchase financings” may vary in practice resulting in significantly different accounting outcomes. However, we believe that transactions that meet the requirements to be considered “linked” under US GAAP generally would result in similar accounting under IFRS (that is, no sale accounting for the initial transfer of financial assets) because, in those instances, the transferor will not have transferred substantially all of the risks and rewards of ownership.
and repurchase financing is readily obtainable in the marketplace.

- The financial asset and repurchase agreement are not coterminous.

If the transactions meet all of the criteria for separate accounting specified above, the initial transfer is accounted for separately from the repurchase financing. That is, the initial transfer is evaluated to determine if it meets the requirements for sale accounting under ASC 860 without taking into consideration the repurchase financing. The initial transferor and initial transferee should then analyze the repurchase financing as a repurchase agreement under ASC 860.

If the transactions do not meet all of the criteria specified above, the initial transfer and repurchase financing should be evaluated as a linked transaction, which should be evaluated to determine whether it meets the requirements for sale accounting under ASC 860. If the linked transaction does not meet the requirements for sale accounting, the transaction should be accounted for based on the economics of the combined transactions. Those economics generally will be consistent with a forward contract. ASC 815 should be used to evaluate whether the linked transaction must be accounted for as a derivative and remeasured at fair value. Refer to EY's Financial Reporting Developments publication, Transfers and Servicing of Financial Assets, for additional guidance.

**Implications**

Under US GAAP, the lender-transferor will recognize the securities pledged as collateral, and a corresponding liability representing the obligation to return the securities received as collateral, provided it has the right by contract or custom to sell or pledge the collateral received. In other words, the lender-transferor accounts for the securities collateral as if the collateral was sold and cash received. In contrast, IFRS requires a lender-transferor to recognize collateral received and a corresponding obligation to return the collateral to the borrower-transferee, only when the collateral is sold.

The accounting for securities lending transactions and repurchase agreements will often be the same (i.e., secured borrowing rather than sale accounting) under both US GAAP and IFRS. However, differences in accounting can result because the US GAAP model focuses on transfer of control while IFRS considers transfer of risks and rewards of ownership.

**Identified difference?**

[ ] Yes  [ ] No  [ ] Depends on policy election

Describe:
C  Glossary

This appendix defines terms used in ASC 860, which are also included in the ASC Master Glossary.

Adequate compensation  The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

Affiliate  A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

Agent  A party that acts for and on behalf of another party. For example, a third-party intermediary is an agent of the transferor if it acts on behalf of the transferor.

Attached call option  A call option held by the transferor of a financial asset that becomes part of and is traded with the underlying instrument. Rather than being an obligation of the transferee, an attached call option is traded with and diminishes the value of the underlying instrument transferred subject to that call option.

Bankruptcy-remote entity  An entity that is designed to make remote the possibility that it would enter bankruptcy or other receivership.

Beneficial interests  Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through

b. Premiums due to guarantors

c. Commercial paper obligations

d. Residual interests, whether in the form of debt or equity

Benefits of servicing  Revenues from contractually specified servicing fees, late charges, and other ancillary sources, including float.
Cash
Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.

Cleanup call option
An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

Collateral
Personal or real property in which a security interest has been given.

Consolidated affiliate
An entity whose assets and liabilities are included in the consolidated, combined, or other financial statements being presented.

Continuing involvement
Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obliges the transferor to provide additional cash flows or other assets to any party related to the transfer.

Contractually specified servicing fees
All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets.

Controlled amortization method
Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which a predetermined monthly payment schedule is established so that payout to the investors will occur over a specified liquidation period. Principal payments are allocated to the investors based on their participation interests in the receivables in the trust, using one of the liquidation methods (fixed, preset, or floating). Principal payments in excess of the predetermined monthly payment, if any, are allocated to the transferor and increase the investors' ownership interests. If the principal payments allocated to the investors are insufficient to cover the predetermined monthly payment, that payment is reduced by the amount of the deficiency. If the principal payments allocated to the investors in subsequent months exceed the predetermined monthly payment, the deficiency is recovered.
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<td><strong>Derecognize</strong></td>
<td>Remove previously recognized assets or liabilities from the statement of financial position.</td>
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<td><strong>Derivative financial instrument</strong></td>
<td>A derivative instrument (as defined in ASC 815) that is a financial instrument.</td>
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| **Dollar-roll repurchase agreement**      | An agreement to sell and repurchase similar but not identical securities. The securities sold and repurchased are usually of the same issuer. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased have all of the following characteristics:  
  a. They are represented by different certificates.  
  b. They are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages).  
  c. They generally have different principal amounts.  
  Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement. |
| **Embedded call option**                  | A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond. |
| **Equitable right of redemption**         | The right of a property owner who has defaulted on a secured obligation to recover the securing property before its sale by paying the amounts due and any appropriate fees and charges. Other creditors of or a receiver for the property owner also may be able to exercise that right. After a transfer of a financial asset, a right of redemption may allow the transferor to buy back the transferred asset. |
| **Financial asset**                       | Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:  
  a. Receive cash or another financial instrument from a second entity  
  b. Exchange other financial instruments on potentially favorable terms with the second entity.  
  A financial asset exists if and when two or more parties agree to payment terms and those payment terms are reduced to a contract. To be a financial asset, an asset must arise from a contractual agreement between two or more parties, not by an imposition of an obligation by one party on another. |
Financial instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
   1. To deliver cash or another financial instrument to a second entity
   2. To exchange other financial instruments on potentially unfavorable terms with the second entity

b. Conveys to that second entity a contractual right either:
   1. To receive cash or another financial instrument from the first entity
   2. To exchange other financial instruments on potentially favorable terms with the first entity

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements— that is, they may be off-balance-sheet— because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

Financial liability

A contract that imposes on one entity an obligation to do either of the following:

a. Deliver cash or another financial instrument to a second entity
b. Exchange other financial instruments on potentially unfavorable terms with the second entity

Fixed participation method

Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which all principal payments on the receivables in the trust are allocated to the investors based on their respective participation interests in the credit card receivables in the trust at the end of the reinvestment period.

Floating participation method

Liquidation method used to allocate principal payments on the receivables in a trust to the investors, under which principal payments allocated to the investors are based on the investors’ actual participation interests in the receivables in the trust each month. Each month, investors’ participation interests in the credit card receivables in the trust are redetermined for that month’s allocation of principal payments.
Freestanding call option

A call that is neither embedded in nor attached to an asset subject to that call option.

Government National Mortgage Association Rolls

The term Government National Mortgage Association (GNMA) rolls has been used broadly to refer to a variety of transactions involving mortgage-backed securities, frequently those issued by the GNMA. There are four basic types of transactions:

a. Type 1: Reverse repurchase agreements for which the exact same security is received at the end of the repurchase period (vanilla repo)

b. Type 2: Fixed coupon dollar reverse repurchase agreements (dollar repo)

c. Type 3: Fixed coupon dollar reverse repurchase agreements that are rolled at their maturities, that is, renewed in lieu of taking delivery of an underlying security (GNMA roll)

d. Type 4: Forward commitment dollar rolls (also referred to as to-be-announced GNMA forward contracts or to-be-announced GNMA rolls), for which the underlying security does not yet exist

Interest-only strip

A contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset.

Liquidation method

The method used to allocate the principal payments on the receivables in a trust to the investors.

Loan origination fees

Origination fees consist of all of the following:

a. Fees that are being charged to the borrower as prepaid interest or to reduce the loan’s nominal interest rate, such as interest buy-downs (explicit yield adjustments)

b. Fees to reimburse the lender for origination activities

c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)

d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because a loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 310-20-25-19)

e. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. This term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending or leasing transaction and also includes syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.
Loan participation

A transaction in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to groups of banks or other entities.

Loan syndication

A transaction in which several lenders share in lending to a single borrower. Each lender loans a specific amount to the borrower and has the right to repayment from the borrower. It is common for groups of lenders to jointly fund those loans when the amount borrowed is greater than any one lender is willing to lend.

Nonpublic entity

Any entity other than one with any of the following characteristics:

a. Whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally.

b. That is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c. That makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. That is controlled by an entity covered by a., b., or c.

Conduit debt securities refers to certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing financing for a specific third party (the conduit bond obligor) that is not a part of the state or local government’s financial reporting entity. Although conduit debt securities bear the name of the governmental entity that issues them, the governmental entity often has no obligation for such debt beyond the resources provided by a lease or loan agreement with the third party on whose behalf the securities are issued. Further, the conduit bond obligor is responsible for any future financial reporting requirements.

Participating interest

A participating interest has the following characteristics:

a. From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset. The percentage of ownership interests held by the transferor in the entire financial asset may vary over time, while the entire financial asset remains outstanding as long as the resulting portions held by the transferor (including any participating interest retained by the transferor, its consolidated affiliates included in the financial statements being presented, or its agents) and the transferee(s) meet the other characteristics of a participating interest. For example, if the transferor’s interest in an entire financial asset changes because it subsequently sells another interest in the entire financial asset, the interest held initially and subsequently by the transferor must meet the definition of a participating interest.
Participating interest (continued)

b. From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace. In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows.

c. The rights of each participating interest holder (including the transferor in its role as a participating interest holder) have the same priority, and no participating interest holder’s interest is subordinated to the interest of another participating interest holder. That priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any other participating interest holder. Participating interest holders have no recourse to the transferor (or its consolidated affiliates included in the financial statements being presented or its agents) or to each other, other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder. For example, if a participating interest holder also is the servicer of the entire financial asset and receives cash in its role as servicer, that arrangement would not violate this requirement.

d. No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Preset participation method

Liquidation method used to allocate principal payments on receivables in a trust to investors. The preset participation method is similar to the fixed participation method except that the percentage used to determine the principal payments allocated to the investors is preset higher than the investors’ expected participation interests in the receivables in the trust at the end of the reinvestment period. This method results in a faster payout to the investors than the fixed participation method because a higher percentage of the principal payments are allocated to the investors.
<p>| <strong>Proceeds</strong> | Cash, beneficial interests, servicing assets, derivative instruments, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred. |
| <strong>Protection provisions</strong> | Provisions in some contracts to sell or transfer mortgage servicing rights that could affect the amount ultimately paid to the transferor. For example, the transferor may agree to adjust the sales price for loan prepayments, defaults, or foreclosures that occur within a specified period of time. |
| <strong>Publicly traded entity</strong> | Any entity that does not meet the definition of a nonpublic entity. |
| <strong>Recourse</strong> | The right of a transferee of receivables to receive payment from the transferor of those receivables for any of the following: a. Failure of debtors to pay when due b. The effects of prepayments c. Adjustments resulting from defects in the eligibility of the transferred receivables |
| <strong>Remote</strong> | The chance of the future event or events occurring is slight. |
| <strong>Repurchase agreement</strong> | An agreement under which the transferor (repo party) transfers a security to a transferee (repo counterparty or reverse party) in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated interest factor. Instead of cash, other securities or letters of credit sometimes are exchanged. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred. |
| <strong>Repurchase financing</strong> | A repurchase agreement that relates to a previously transferred financial asset between the same counterparties (or consolidated affiliates of either counterparty) that is entered into contemporaneously with, or in contemplation of, the initial transfer. |
| <strong>Revolving-period securitizations</strong> | Securitizations in which receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms. |
| <strong>Securitization</strong> | The process by which financial assets are transformed into securities. |</p>
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<td>Security</td>
<td>A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:</td>
</tr>
<tr>
<td></td>
<td>a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.</td>
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<td></td>
<td>b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.</td>
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<td></td>
<td>c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.</td>
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<tr>
<td>Security interest</td>
<td>A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.</td>
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<td>Seller</td>
<td>A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.</td>
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<td>Servicing assets</td>
<td>A contract to service financial assets under which the benefits of servicing are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either:</td>
</tr>
<tr>
<td></td>
<td>a. Undertaken in conjunction with selling or securitizing the financial assets being serviced</td>
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<td></td>
<td>b. Purchased or assumed separately</td>
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<td>Servicing liability</td>
<td>A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues (benefits of servicing) are not expected to adequately compensate the servicer for performing the servicing.</td>
</tr>
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<td>Set-off right</td>
<td>A common law right of a party that is both a debtor and a creditor to the same counterparty to reduce its obligation to that counterparty if that counterparty fails to pay its obligation.</td>
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<td>Standard representations and warranties</td>
<td>Representations and warranties that assert the financial asset being transferred is what it is purported to be at the transfer date.</td>
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Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset.

A transfer includes the following:

a. Selling a receivable
b. Putting a receivable into a securitization trust
c. Posting a receivable as collateral.

A transfer excludes the following:

a. The origination of a receivable
b. Settlement of a receivable
c. The restructuring of a receivable into a security in a troubled debt restructuring

Transferee

An entity that receives a financial asset, an interest in a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, an interest in a financial asset, or a group of financial assets that it controls to another entity.

Transferred financial assets

Any of the following:

a. An entire financial asset
b. A group of entire financial assets
c. A participating interest in an entire financial asset

Unilateral ability

A capacity for action not dependent on the actions (or failure to act) of any other party.
### Abbreviations used in this publication

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